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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1955

No. 286

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER

vs.

SOUTHWEST EXPLORATION COMPANY,
A CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED AUGUST 2, 1955
CERTIORARI GRANTED OCTOBER 10, 1955

No. 13875

United States Court of Appeals

for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

SOUTHWEST EXPLORATION COMPANY, a Corporation,

Respondent.

Transcript of Record

Petition to Review a Decision of the Tax Court of the United States

Philips & Van Orden Co., 870 Brannan Street, San Francisco, Calif.

INDEX

[Clerk's Note: When deemed likely to be of important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES

For Petitioner:

MELVIN D. WILSON, Esq.,
JOSEPH D. PEELER, Esq.

For Respondent:

B. H. NEBLETT, Esq.

Docket No. 24872

SOUTHWEST EXPLORATION COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1949

Sept. 7—Petition received and filed. Taxpayer notified. Fee paid.

Sept. 8—Copy of petition filed on General Counsel.

Oct. 31—Answer filed by General Counsel.

Oct. 31—Request for hearing in Los Angeles, Calif., filed by General Counsel.

Nov. 2—Notice issued placing proceeding on Los Angeles, Calif., calendar. Service of Answer and Request made.

1950

Apr. 10—Motion for leave to file attached amended petition, amended petition lodged, filed by taxpayer.

1950

Apr. 11—Motion for leave to file attached amended petition, granted—Amended petition filed.

Apr. 12—Copy of motion and amended petition served on General Counsel.

May 2—Answer to amended petition filed by General Counsel. 5/8/50—Copy served.

1951

Mar. 28—Motion for leave to amend answer embodying amendment to amended petition filed by General Counsel. 3/39/51—Granted.

Apr. 13—Hearing set July 2, 1951, Los Angeles, Calif.

July 9—Hearing had before Judge Van Fossan on merits. Motion of W. J. McFarland, Esq., and E. D. Yeomans, Esq., to file Briefs amicus curiae—petitioner's counsel objects. Motion granted—filed at hearing. Stipulation of Facts with Exhibits 1-A through 16-P attached, filed. Petitioner's Brief—Sept. 7, 1951. Respondent's Brief Oct. 22, 1951. Petitioner's Reply—Nov. 21, 1951.

Aug. 6—Transcript of Hearing, 7/9/51, filed.

Aug. 16—Motion to correct transcript filed by taxpayer.

Sept. 5—Brief filed by taxpayer—accept brief amicus curiae—due Oct. 22, 1951. 9/6/51—Copy served.

1951

Oct. 22—Brief amici curiae of Pacific Electric Railway Company and Pacific Electric Land Company, filed by E. D. Yeomans, Esq., and F. J. Gallagher, Esq.

Oct. 22—Brief amicus curiae of Huntington Beach Co. filed by Sigvald Nielson, Esq., Harry R. Horrow, Esq., and W. J. McFarland, Esq. Copy served.

Oct. 22—Reply Brief filed by General Counsel.

Nov. 21—Rebuttal Brief filed by Taxpayer. Copy served.

1952

Sept. 10—Findings of Fact and opinion rendered. Judge Van Fossan. Decision will be entered under Rule 50. Copy served.

1953

Jan. 5—Respondent's computation filed.

Jan. 8—Decision entered. Judge Van Fossan, Div. 9.

Mar. 23—Petition for Review by U. S. Court of Appeals for the Ninth Circuit, filed by General Counsel.

Apr. 6—Proof of Service filed, 2, on taxpayer and Attorney.

Apr. 20—Motion for extension to June 19, 1953, to prepare and transmit the record filed by General Counsel.

Apr. 21—Order enlarging time to June 19, 1953, to prepare and transmit the record entered.

May 13—Statement of Points filed by General Counsel.

1953

May 13—Designation of Contents of Record with statement of service by mail to Melvin D. Wilson, Esq., thereon, filed by General Counsel.

June 1—Proof of Service of Designation of Record filed.

June 1—Proof of Service of Statement of Points filed.

The Tax Court of the United States

Docket No. 24872

SOUTHWEST EXPLORATION COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto through their respective counsel that the following statements are true and that such facts may be considered by the Tax Court as offered in evidence by the parties to the proceeding, provided, however, that this stipulation shall be without prejudice to the rights of either party to introduce further evidence not inconsistent with the facts herein stipulated:

1. The petitioner is a corporation organized under the laws of California and was incorporated on June 20, 1933. Its principal office and place of business is 811 West Seventh Street, Los Angeles, California.

2. The petitioner filed its federal corporate income, and declared value excess profits tax and excess profits tax returns for the calendar years 1938 to 1945, inclusive, with the Collector of Internal Revenue for the sixth district of California at Los Angeles, California.

3. Attached hereto and marked "Exhibit 1-A" hereof is a true copy of "Notice of Intention of State Lands Commission to Receive Offers to Enter into an Agreement or Agreements for Extraction of Oil and Gas and Other Hydrocarbons from Certain Tide and Submerged Lands of the State, Situate in Orange County, California," hereinafter sometimes referred to as the "Notice". The legal descriptions set forth in the original notice are omitted from Exhibit 1-A for the sake of brevity. The legal description was divided into five parcels, designated "A", "B", "C", "D", and "E". Each parcel was said to contain 167 acres, more or less. It is stipulated by the parties hereto that the area of tidelands and submerged lands identified in the original notice as Parcels A-E, inclusive, of said Orange County, California, tidelands and submerged lands, constituted the entire area covered by State Easement No. 392 which the petitioner subsequently obtained from the State of California in the manner herein-

after set forth. The above-described notice was published during the period August 8-13, 1938, inclusive.

4. Prior to the transmittal of its bid for the state easement subsequently identified as "State Easement No. 392" the petitioner as "Permittee" entered into an agreement for a permit, dated August 25, 1938, with Huntington Beach Company, a corporation, Pacific Electric Railway Company, a corporation, Pacific Electric Land Company, a corporation, Bolsa Land Company, a corporation, Bolsa Chica Gun Club, a corporation, and Standard Oil Company of California, a corporation, as "Permittors". Attached hereto and marked "Exhibit 2-B" hereof is a true and correct copy of the above-described agreement. It is stipulated by the parties that the lands referred to as "uplands" in the agreement identified as Exhibit 2-B hereof, and more particularly described in the first "whereas" paragraph appearing on page 1 of said Exhibit 2-B, constituted all of those lands referred to as littoral lands and uplands in Section 1 of Agreement for Easement No. 392 and elsewhere therein, which are more particularly described in Section 1 thereof. Said Agreement for Easement constitutes Exhibit 5-E of this stipulation.

5. Attached hereto and marked "Exhibit 3-C" hereof is a correct copy of an agreement entered into on August 29, 1938, by and between Bolsa Land Company, a corporation, and Southwest Exploration Company, a corporation. No wells had been

drilled on the property referred to in said agreement prior to December 31, 1945.

6. In accordance with the terms and conditions of the notice, the petitioner submitted its bid to the State Lands Commission on August 30, 1938. Attached hereto and marked "Exhibit 4-D" hereof is a correct copy of the letter transmitting petitioner's bid for easement. It is stipulated that with said transmittal letter the petitioner filed with the State Lands Commission were the following documents:

(a) Form of agreement for State Easement, later identified as "No. 392," with date omitted, but signed by petitioner, through its president and secretary; attached to the said agreement for State Easement No. 392 were those portions of Exhibit 5-E appearing at the end thereof, entitled "Endorsement by Upland Owners," "Exhibit A (for entire tract)" and "Exhibit B";

(b) Permit agreement identified as Exhibit 2-B of this stipulation;

(c) Cashier's check for $15,000.00 payable to the Treasurer of the State of California;

(d) Certified copies of resolutions authorizing petitioner's officers to execute Exhibit 2-B and Exhibit 5-E hereof;

(e) Certificate of ownership showing that all of petitioner's stockholders were residents of the State of California.

It is further stipulated that petitioner's bid con-

formed in all respects to the requirements of the State Lands Commission. The petitioner furnished the $25,000.00 bond required by the agreement for State Easement No. 392.

7. In accordance with the terms and provisions of the "State Lands Act of 1938, Chapter 5, Statutes of California, Extra Session, 1938," the petitioner's bid was accepted and it entered into an Agreement for State Easement No. 392 with the State Lands Commission on September 26, 1938. Attached hereto and marked "Exhibit 5-E" hereof is a correct copy of said Agreement for State Easement No. 392.

8. Attached hereto and marked "Exhibit 6-F" and "Exhibit 7-G" are maps showing the location of petitioner's wells in the area covered by State Easement No. 392 with respect to the Main Zone and to the Jones Zone, respectively. It is stipulated that said maps are correct in so far as they attempt to show the locations of the tops and bottoms of petitioner's wells, the location of Standard Oil Company of California's vertical upland wells, the numbers assigned to petitioner's wells and Standard Oil Company of California's wells as of December 31, 1945, and the names of the owners and lessees of the uplands. There were no "filled lands" as that term is used in Article 6 of the State Lands Act of 1938, Chapter 5, Statutes of California, Extra Session, 1938, which were situated adjacent or contiguous to or otherwise usable or available in the extraction and exploitation of oil, gas or other hydrocarbon

substances from the area constituting State Easement No. 392.

9. Attached hereto and marked "Exhibit 8-H," hereof is a correct copy of an agreement dated August 25, 1938, between Huntington Beach Company, a corporation, Pacific Electric Railway Company, a corporation, Pacific Electric Land Company, a corporation, and Standard Oil Company of California, a corporation, and petitioner. The agreement refers in its text to "Exhibit 1" thereof which is identified as Exhibit 2-B of this stipulation.

10. Exhibit 9-I of the stipulation is a correct copy of an agreement dated September 27, 1938, between petitioner, as party of the first part, and Pacific Electric Railway Company, a corporation, Pacific Electric Land Company, a corporation, and Huntington Beach Company, a corporation, as second parties.

11. Attached hereto and marked "Exhibit 10-J" and "Exhibit 11-K" of this stipulation are amendments to the Agreement for State Easement No. 392, duly executed on December 6, 1938, and March 22, 1939, respectively.

12. Attached hereto and marked "Exhibit 12-L" hereof is a schedule for the years 1938-1945, inclusive, reflecting the number of wells drilled by petitioner under State Easement No. 392, the respective years in which the said wells were completed, and the total crude oil production therefrom for the years 1938-1945, inclusive. The well numbers

appearing on the schedule correspond to the well numbers appearing on Exhibit 6-F and Exhibit 7-G of this stipulation, and the geographical location of the top and bottom of each well here involved can be ascertained by reference to said Exhibits 6-F and 7-G.

13. It is stipulated that petitioner has, in its returns for the first year in which intangible oil well drilling and development costs were incurred, exercised the option granted it in Regulation 101, Article 23(M)-16(a)-1 and Regulation 111, section 29.23(m)-16, to deduct such items from gross income as expenses.

14. Petitioner drilled wells under its Agreement for Easement No. 392, dated September 26, 1938, and incurred intangible drilling and development costs, as defined in Regulation 101, Article 23(M)-16 (a)-1 and Regulation 111, section 29.23(m)-16, as shown below, and charged its claimed share to expense. Respondent disallowed all of such intangible expenses which had been deducted by petitioner, and respondent capitalized them as items returnable through depletion or depreciation, in accordance with Regulation 101, Article 23(M)-16(a)-1 and Regulation 111, section 29.23(m)-16, (a)(2).(i) and (ii), as shown below. The first eleven wells drilled by petitioner in 1938 and 1939 pursuant to State Easement No. 392, offset existing wells of Standard Oil Company of California as shown on Exhibits 6-F and 7-G, and petitioner is not protesting the disallowance of their intangible drilling and devel-

opment costs. Thereafter, petitioner continued the drilling of wells in accordance with the terms of State Easement No. 392.

Petitioner claims that it is entitled to deduct 89⅜ per cent of the intangible drilling and development costs of the other wells, drilled in 1939 to 1942, inclusive, pursuant to the terms of State Easement No. 392. As to wells drilled after December 31, 1942, the respondent has, under Regulation 101, Article 23(M)-16 (a)-1 and Regulation 111, section 29.23 (m)-16, (b), allowed petitioner to deduct 89⅜ per cent of all intangible drilling and development costs.

SOUTHWEST EXPLORATION COMPANY

Intangible Drilling and Development Costs on State Easement No. 392

Year	Total 100%	Lawson, et al. 10⅝%	Petitioner 89⅜%	Capitalized by Respondent as Depreciable	Capitalized by Respondent as Depletable
1938					
Offset wells	$149,181.50	$15,850.54	$133,330.96	$56,930.71	$ 76,400.25
1939					
Offset wells	100,293.97	10,656.23	89,637.74	27,404.75	86,278.10
Other wells	320,929.87	34,098.80	286,831.07	69,679.02	193,106.94
Totals	$421,223.84	$44,755.03	$376,468.81	$97,083.77	$279,385.04
1940	$205,834.10	$21,869.87	183,964.23	47,204.18	136,759.75
1941	253,625.69	26,947.73	226,677.96	56,721.09	169,956.87
1942	176,944.24	18,800.33	158,143.91	37,963.85	120,180.06

15. The respondent has in accordance with Regulation 101, Article 23(M)-16(a)-1 and Regulation 111, section 29.23(m)-16(a) (2) (ii) allowed depreciation deductions to petitioner on the items which respondent capitalized as being subject to depreciation, as follows:

Southwest Exploration Company

Statement of Division of Depreciation on Capitalized Intangibles Classified as Depreciable Between the First Eleven Wells and the Subsequent Wells

Year	Total Depreciation Allowed	Depreciation Allowable on First 11 Wells	Depreciation Allowable on Subsequent Wells
1938	$ 28.09	$ 14.64	$ 13.45
1939	7,865.07	2,914.20	4,950.87
1940	16,410.92	4,623.99	11,786.93
1941	18,811.88	4,048.63	14,763.25
1942	28,277.51	5,511.31	22,766.20
1943	22,433.30	4,422.32	18,010.98
1944	25,525.47	4,797.60	20,727.87
1945	21,971.92	4,090.87	17,881.05
Total	$141,324.16	$ 30,423.56	$110,900.60

It is stipulated that petitioner is entitled to such depreciation deductions on the eleven offset wells in any event; as to the other wells, it is stipulated that if petitioner is held to be entitled to deduct its 80% per cent of the intangible drilling and development costs, then petitioner will not be entitled to the depreciation deductions set out above, but if petitioner is held to be not entitled to deduct said intangible costs, it will be entitled to such depreciation deductions.

16. Petitioner did not drill or deepen and was

not required to drill or deepen, any wells prior to January 1, 1943, under the conditions specified in the third and fourth paragraphs beginning on page 2 of Exhibit A attached to Joint Exhibit 5-E of the stipulation.

17. Eleven of the wells referred to in Exhibit 5-E offset eleven verticle wells which had been drilled by Standard Oil Company of California on the uplands known as the Pacific Electric Right of Way. The eleven offset wells drilled by petitioner had their tops on the uplands and were slanted seaward, and the bottoms of all were within 350 feet of ordinary high-water mark, and were drilled into the Main Zone. Said wells were drilled and completed in accordance with the terms of said Easement No. 392, and Exhibit A attached thereto.

18. Petitioner also developed the Jones Zone, all of the wells in that zone being marked J-1, J-2, etc. in the Joint Exhibit 7-G.

The tops of all of petitioner's wells drilled pursuant to the terms of State Easement No. 392 and in accordance with the terms of petitioner's agreements with the upland owners (Exhibits 2-B, 8-H and 9-I, respectively, of this stipulation) during the years 1938 to 1945, inclusive, are on upland property owned by the Huntington Beach Company. Said wells were drilled on a slant toward the ocean and accordingly went through and under land owned by the Huntington Beach Company and land owned or leased by Pacific Electric Railway Company and Pacific Electric Land Company so

that the bottom of said wells were out under the Pacific Ocean.

19. All surface operations in connection with the drilling and operation of the wells covered by State Easement No. 392 were conducted by petitioner on the lands owned by Huntington Beach Company. Petitioner erected on the lands owned by said Huntington Beach Company all the ordinary facilities including its field office, settling and shipping tanks, pipe lines, and other equipment and appliances required in connection with its business operations. Petitioner's investment in such assets is reflected in the trial balances Exhibit 15-O of this stipulation, on the line identified as "Account No. 301" entitled "Plant and Equipment." Under the provisions of State Easement No. 392 it was required that each well be drilled by slant drilling from the uplands to and into the sub-surface of the state lands covered by State Easement No. 392. All sub-surface operations in connection with the drilling and operation of the wells covered by State Easement No. 392 were conducted from and through the land owned by the Huntington Beach Company, and through land owned or leased by the Pacific Electric Railway Company and the Pacific Electric Land Company.

20. The petitioner makes payments to others of portions of the gross income, net income, or of the gross oil and gas produced. These payments are not involved in the instant proceeding. In addition thereto the petitioner pays out "an amount equal to the following percentages of the 'net profits'"

as determined under Exhibit 9-I from the operation of the wells here involved as shown below:

Huntington Beach Company	17.75%
Pacific Electric Railway Company	1.576
Pacific Electric Land Company	5.174
Total	24.5%

The above-listed payments are paid to the payees indicated in accordance with the terms and provisions of Exhibit 9-I attached to this stipulation and the terms and provisions of the agreements referred to in said agreement 9-I of this stipulation.

21. The following figures relating to the depletion issue are stipulated.

(a) If petitioner is entitled to include in its gross income, the amount equal to the payments specified in the preceding paragraph paid to the "upland owners," and if petitioner is entitled to deduct 89⅜ per cent of the intangible drilling and development costs, and if petitioner is not entitled to deduct any franchise taxes not allowed in the deficiency letter, petitioner will be entitled to additional depletion deductions as follows:

1941	$ 19,443.62
1942	96,189.89
1943	91,452.47
1944	218,032.38
1945	244,764.71

If petitioner is entitled to additional deductions for franchise taxes, the additional depletion, if any, will be computed under Rule 50.

(b) If the factors are the same as stated in subparagraph (a) above, except that petitioner is not entitled to deduct 893/8 per cent of intangible drilling and development costs, then petitioner will be entitled to additional depletion deductions as follows:

1941	$ 35,874.23
1942	96,189.89
1943	82,446.98
1944	218,032.38
1945	244,764.71

If petitioner is entitled to additional deductions for franchise taxes, the additional depletion, if any, will be computed under Rule 50.

22. It is hereby stipulated that petitioner has paid federal corporate taxes as follows:

Year	Date	Income Tax	Declared Value Excess Profits Tax	Excess Profits Tax
1939	3-15-40	$ 2,907.75	$	.....
	1-26-50	32,114.88	20,455.80	.....
Totals		$35,022.63	$20,455.80	$ .....

Year	Date	Income Tax	Declared Value Excess Profits Tax	Excess Profits Tax
1940	3-13-41	$11,500.00		$ .....
	6-13-41	8,354.47		11,427.84
	9-12-41	9,927.23		5,713.92
	12-11-41	9,927.23		5,713.92
	1-26-50	31,271.85	$5,973.03	24,545.60
Totals		$70,980.78	$5,973.03	$ 47,401.28

Year	Date	Income Tax	Declared Value Excess Profits Tax	Excess Profits Tax
1941	3- 6-42	$13,429.47		$ 30,471.52
	6- 7-42	13,429.47		30,471.52
	9-11-42	13,429.48		30,471.52
	12-11-42	13,429.47		30,471.52
	1-26-50	5,470.28		54,525.59
	Totals	$59,188.17		$176,411.67
1942	3-15-43	$ 7,500.00		$ .....
	3-15-43	3,078.59		56,921.41
	6-15-43	18,153.59		56,921.41
	9-15-43	1,742.09		56,921.41
	12-3-43	.....		50,075.00
	12-15-43	10,158.09		6,846.41
	1-26-50	34,075.82	$6,996.71	81,158.14
	Totals	$74,708.18	$6,996.71	$308,843.78
1943	3-13-44	$ 7,000.00		$ .....
	3-15-44	.....		74,000.00
	6-15-44	6,983.35		80,079.16
	9-14-44	6,991.68		77,016.95
	12-14-44	6,991.67		77,016.96
	1-26-50	46,767.42		
	1-13-48			(45.25) Refund
	Totals	$74,734.12	.....	$308,067.82
1944	3-15-45	$12,500.00		$140,000.00
	5- 1-45	.....		4,129.41
	6-15-45	9,956.00		144,129.95
	9-12-45	11,228.00		115,304.49
	12-14-45	11,227.95		115,303.95
	1-26-50	31,822.17	$2,982.50	34,102.12
	Totals	$76,734.12	$2,982.50	$552,969.92

September 28, 1945—Post War credit allowed $ 57,651.98

Year	Date	Income Tax	Declared Value Excess Profits Tax	Excess Profits Tax
1945	3- 6-46	$ 7,210.45		$154,616.34
	6-13-46	7,210.45		154,616.34
	9- 6-46	7,210.45		154,616.34
	12-11-46	7,210.44		154,616.34
	1-26-50	47,892.34	$8,764.91	22,219.31
Totals		$76,734.12	$8,764.91	$640,684.67

23. Petitioner filed its federal corporate income and excess profits tax returns as follows:

Year	Date	Date to Which Extension for Filing Granted
1939	3-15-40	——
1940	6-13-41	6-15-41
1941	3- 6-42	——
1942	5-14-43	5-15-43
1943	6-15-44	6-15-44
1944	5- 1-45	5-15-45
1945	3- 6-46	——

24. It is stipulated that respondent assessed additional income taxes against petitioner on August 11, 1944, as follows: 1939—$12,643.54; 1940—$21,305.83; 1941—$55,061.55; also declared value excess profits tax for 1939 of $118.01. Petitioner has not paid said assessments.

25. Attached hereto and marked "Exhibit 13-M" hereof is a copy of an agreement between petitioner and the State of California, dated August 12, 1943.

26. Attached hereto and marked "Exhibit 14-X" hereof is a schedule reflecting amounts equal to 24½ percent of net profits paid by petitioner to the upland owners, Huntington Beach Company, Pacific Electric Railway Company and Pacific Electric Land Company, during the years 1938

1945, inclusive, pursuant to agreement dated September 27, 1938, identified as Exhibit 9-I of this stipulation.

27. Attached hereto and marked "Exhibit 15-O" is a Trial Balance by years for the years 1938 to 1945, inclusive, taken from petitioner's books. The word "participants" includes the "upland owners" and the "Lawson interests".

28. Petitioner has from its inception, kept its books and filed its income tax returns upon the accrual basis.

The franchise tax authorities of the State of California have now proposed additional franchise taxes against petitioner for the years 1939 to 1946, inclusive, based on adjustments of income similar to those set out in the "deficiency letter", and the franchise tax officials have requested and obtained from petitioner, agreements waiving the statute of limitations for assessing additional franchise taxes, for the years 1939 to 1946, inclusive. Attached hereto is a statement by petitioner entitled "Protest" relating to franchise taxes for the years 1939-1946, inclusive, identified as "Exhibit 16-P", the original of which was filed with the California Franchise Tax Board on or about April 4, 1951.

s/ MELVIN D. WILSON,
s/ JOSEPH D. PEELER,
Counsel for Petitioner.

s/ CHARLES OLIPHANT,
Chief Counsel, Bureau of Internal Revenue, Counsel for Respondent.

EXHIBIT 1-A

Notice of Intention of State Lands Commission to Receive Offers to Enter into an Agreement or Agreements for Extraction of Oil and Gas and Other Hydrocarbons from Certain Tide and Submerged Lands of the State Situate in Orange County, California.

Notice is hereby given by the State Lands Commission acting pursuant to "State Lands Act of 1938" (Chapter 5, Statutes of California, Extra Session 1938) of intention to enter into an agreement or agreements for the purpose of extraction of oil and gas and other hydrocarbons from those certain parcels of tidelands and submerged lands situate in the County of Orange, State of California, more particularly described as follows, to-wit:

Parcel "A"
Parcel "B"
Parcel "C"
Parcel "D"
Parcel "E"

Each bidder may propose to enter into an agreement with the State of California for the extraction of oil, gas and other hydrocarbons from the hereinbefore described Parcels identified as "A," "B," "C," "D," and "E," as one tract, or from one or more of said parcels.

Each bidder, as a condition precedent to the consideration of such bidder's bid, in addition to other qualifications contained in "State Lands Act of 1938," shall present at the time of delivery of

Exhibit 1-A—(Continued)

such bid or bids to the State Lands Commission evidence satisfactory to the Commission of the present ability of such bidder to furnish all necessary sites and rights-of-way without cost or obligation to the State for all operations contemplated under the provisions of form of bid, and any bid not accompanied by such evidence will be rejected by the Commission.

Evidence of the present ability of a bidder to furnish all necessary sites and rights of way for the operations contemplated under the provisions of the form of agreement for easement shall include the following:

(1) The owner or owners of real property described as the "uplands" in said agreement shall execute the endorsement on said agreement acknowledging that the bidder has been granted all such necessary sites, rights of way and easements; and

(2) The bidder shall transmit to the commission with his bid either (a) the instrument or instruments, or certified copies thereof, vesting in such bidder such sites, rights of way and easements, or (b) certified copies of such instrument or instruments together with the affidavits of the owners of said uplands that the original copies of such documents have been placed in escrow to be delivered to the bidder in the event the bid is accepted.

The finding of the commission as to whether or not a bidder has the present ability to furnish all necessary sites and rights of way for all opera-

Exhibit 1-A—(Continued)

tions contemplated under the agreement for easement for which the bid is submitted shall be final and conclusive.

Each bid submitted pursuant to this notice shall be accompanied by a certified or cashier's check of a responsible bank in California payable to the Treasurer of the State of California in the sum of $15,000 as a deposit of evidence of good faith, and except in the case of the successful bidder will be returned to the respective bidder. Should the successful bidder fail or refuse to execute the agreement for easement within fifteen days of the award thereof by the commission, the deposit shall be forfeited to the State of California, otherwise the amount of said deposit shall be applied upon the annual rental rate for the first year and the balance, if any, refunded to the Grantee.

All bids made pursuant to this notice shall be addressed to the State Lands Commission, sealed and delivered to State Lands Commission, Room 301, California State Building, Los Angeles, on or before 12 M., of the 1st day of September, 1938. Upon the sealed envelope containing such bid shall be written "Bid of (name of bidder) made pursuant to notice of intention of State Lands Commission to enter into agreement for extraction of oil, gas and other hydrocarbons from the tide and submerged lands of the State of California, in the County of Orange, State of California."

Bids received pursuant to this notice will be publicly opened at 2 p.m., September 1, 1938, at

Exhibit 1-A—(Continued)

Room 301 State Building, Los Angeles, California, or at such later time and date as the Commission shall determine.

Form of bid entitled "Agreement for Easement No....., Huntington Beach," for each of said parcels or for the tract as a whole may be obtained at the office of the Commission in Room 301 California State Building, Los Angeles, California.

The Commission reserves the right to reject any and all bids received pursuant to this notice.

STATE LANDS COMMISSION.
By WEBB SHADLE,
Executive Officer.

Pub: Aug. 8, 9, 10, 11, 12, 13, 1938.

EXHIBIT 5-E

State Lands Commission
State of California

AGREEMENT FOR EASEMENT No. 392
HUNTINGTON BEACH

This Agreement Made and entered into this 26th day of September, 1938, by and between the State of California, through the State Lands Commission of the State of California, party of the first part, hereinafter called the "State" and Southwest Exploration Company, a California corporation, party of the second part, hereinafter called the "Grantee", pursuant to the State Lands Act of 1938, being Chapter 5, Statutes of California, Extra

Exhibit 5-E—(Continued)

Session, 1938, hereinafter referred to as the "Act" and by this reference made a part hereof.

The parties hereto do hereby agree as follows:

Section 1. That the State, in consideration of the royalty to be paid, the covenants to be performed, and the conditions to be observed by the Grantee, as herein set forth, does hereby grant to the Grantee an exclusive easement appurtenant to the lands of the Grantee hereinafter described, through, in and under lands of the State of California (hereinafter referred to as the State lands), hereinafter more particularly described, together with the exclusive right to drain, take, receive, extract, remove, and produce from the State lands oil, gas, and other hydrocarbon substances through certain oil wells to be drilled, operated and maintained by the Grantee in the manner hereinafter provided, the tops of which such wells shall be located upon that portion of those certain littoral lands and uplands lying within a prolongation or projection northerly of the sidelines of the hereinafter described parcel of state lands (which portion is hereinafter referred to as the uplands), which said littoral lands and uplands are situate in the County of Orange, State of California, and more particularly described as follows, to-wit:

> Commencing at a point at the intersection of the ordinary high water mark of the Pacific Ocean with the Southwesterly prolongation of the Northwesterly line of Twenty-third Street in the City of Huntington Beach, thence North-

Exhibit 5-E—(Continued)

easterly along said Southwesterly prolongation of the Northwesterly line of Twenty-third Street and along the Northwesterly line of said Twenty-third Street to a point at the intersection of the Northwesterly line of said Twenty-third Street with the Northwesterly prolongation of the Northeasterly line of Palm Avenue, thence Northwesterly along said Northwesterly prolongation of the Northeasterly line of said Palm Avenue to a point in the Northerly boundary line of the City of Huntington Beach, thence Westerly along the said Northerly boundary of the City of Huntington Beach to the Quarter Section line running North and South through Section Four (4), Township Six (6) South, Range Eleven (11) West, thence S. 40° 36' W. to the ordinary high water mark of the Pacific Ocean, thence Southeasterly along said ordinary high water mark of the Pacific Ocean to the point of beginning, subjects to easements, rights-of-way and other matters of record,

in accordance with the rules and regulations of the State now promulgated and such reasonable rules and regulations of the State as may be promulgated hereafter from those certain lands hereinbefore referred to as the State lands, belonging to the State of California, situate in the County of Orange, State of California, and more particularly described as follows, to wit:

An area of land lying between the extension

Exhibit 5-E—(Continued)

southwesterly of the center line of 23rd Street in the City of Huntington Beach as said center line is shown on a map entitled "Resurvey of part of Section 34, T. 5S., R. 11 W., and part of Sections 3, 4, and 10 of T. 6S., R. 11 W., S.B.M., as per Stearns Rancho Company's Sectionized Survey by Captain T. C. Healey, Surveyor, surveyed by L. G. B. McDowell, field work completed September 15, 1927," filed at page 28 of Book 3 of Maps in the office of the Recorder of the County of Orange and a line extending S. 40° 36' W. from a 2" pipe corner of survey set by V. J. Rowan at the north end of the most westerly course of Lot E as shown upon the above described map and between the ordinary high water mark of the Pacific Ocean and a line parallel to and distant one mile S. 40° 36' W. from the said ordinary high water mark containing 835 acres, more or less.

for a term of twenty (20) years from and after the date hereof, with the option to the Grantee to continue the term of this agreement as to all wells drilled or producing at the expiration of the term hereof, for so long as oil or gas is produced from such wells.

Section 2. The Grantee in consideration of the foregoing hereby agrees:

(a) To furnish a bond in favor of the State of California, and approved by the State in the penal sum of $25,000.00 to guarantee the faithful performance by the Grantee of the terms, covenants

Exhibit 5-E—(Continued)

and conditions of this agreement and of the provisions of the Act.

(b) To commence operations for the drilling of wells into the State lands, and to thereafter continue with such drilling in accordance with the drilling program, attached hereto, marked Exhibit "A", and by reference made a part hereof.

(c) To pay to the State of California a royalty in accordance with the formula, marked Exhibit "B", attached hereto, and by reference made a part hereof, on the oil produced and saved from each well producing from the State lands or on demand the State's percentage of oil produced in accordance with said Exhibit "B", the royalty when paid in money shall be calculated upon the reasonable market price of the production at the well as determined by the State Lands Commission, which price shall not be greater than the highest price at which a major oil company then buying oil of like gravity in substantial quantities from the Huntington Beach, California, oil field, is offering for oil of like gravity and kind at the well, and shall be due and payable not later than the 25th day of each calendar month following the calendar month in which produced, or when paid in kind, to be delivered in the field and taken by the State at the receiving tanks of the Grantee located upon the uplands on forty-eight (48) hours' notice of the Grantee that a tankful of oil will be ready for delivery; to pay to the State of California at the times and in the manner herein specified for the

Exhibit 5-E—(Continued)

payment of royalty on oil, 15% of the market value, at Huntington Beach, California, of all dry gas, natural gasoline and other products extracted and saved from the gas produced from the State lands. Unless such dry gas, natural gasoline or other products are sold pursuant to a sales contract approved by the State, the market value shall be the reasonable market value as fixed by the State.

The State may take its royalty dry gas and natural gasoline in kind at its option, delivery thereof to be made at the natural gasoline manufacturing plant where produced or at such other place as the parties hereto may agree.

(d) To pay to the State annually in advance as rental the sum of one (1) dollar per acre for each acre of State lands herein described which rental shall be credited against the royalties, if any, as they accrue for the year for which such rental is paid.

(e) To file with the State true and correct copies of all sales contracts for the disposition of oil, gas and other hydrocarbon substances produced hereunder and, in the event the State should elect to take such oil or gas royalty or other hydrocarbon substances in money instead of kind not to sell or otherwise dispose of the oil, gas or other hydrocarbon substances hereunder, except in accordance with such sales contracts or other method first approved in writing by the State.

(f) To furnish monthly statements in detail in such form as may be prescribed by the State, show-

Exhibit 5-E—(Continued)

ing, with respect to the wells, the amount, gravity, and market price at the well of all oil produced, saved and sold, the amount of gas produced, saved, and sold and the amount of natural gasoline extracted by the Grantee therefrom during the preceding calendar month, and the number of days each well is on production as the basis for computation of royalties due the State; to keep full and complete records and accounts of the cost of development and the cost of production of oil and gas derived from the wells drilled by the Grantee into the State lands, which said records and accounts shall be available at all reasonable times to the inspection and examination of any person authorized by the State; to an examination of books and records of any individual, association, or corporation which has transported for or received from the Grantee any oil, gas or other hydrocarbon substances produced from the State lands, and to gasoline extracted from gas produced therefrom; to permit inspection at all reasonable times, by any person authorized by the State, of the operations of the Grantee with respect to the wells, improvements, machinery and fixtures used in connection therewith.

(g) To make logs and surveys of all wells drilled by the Grantee into the State lands in accordance with the provisions of this agreement and in accordance with approved current practices of operations of this character in effect at the time of undertaking of such operations, and to file as confidential

Exhibit 5-E—(Continued)

information all such logs and surveys and also all records of well cores and other related information with the Division of Oil and Gas of the Department of Natural Resources of the State of California; to waive the statutory limitations upon the use by the State, or a duly authorized employee of the State, of any such information filed with said Division of Oil and Gas by the Grantee. Any and all information filed by the Grantee with the said Division of Oil and Gas shall be available at all times to the State for the purpose of forcing compliance with the terms, covenants, and conditions of this agreement and rules and regulations now promulgated by the State, and reasonable rules and regulations which may hereafter be promulgated by the State.

(h) To pay when due all taxes lawfully assessed and levied under the laws of the State, County, City, and United States of America, upon improvements, oil, gas, and other hydrocarbon substances produced from the State lands other than taxes upon the State's royalty oil, gas, and other hydrocarbon substances; to accord all workmen and employees freedom of purchase, and to pay wages due workmen and employees in accordance with the laws of the State of California and of the United States of America relating to employment of workmen; to comply with all laws of the State of California and all rules and regulations of any agency of the State of California having jurisdiction therein, and all laws of the United States of America, and all

Exhibit 5-E—(Continued)

rules and regulations of any agency of the United States of America having jurisdiction therein, and all valid ordinances of cities, and counties, applicable to the Grantee's operations, including, without limitation by reason of the specification thereof, the Grantee's compliance with the Act of the State of California creating the office of the State Oil and Gas Supervisor, Statutes of 1915, page 1404, and all amendments thereto.

(i) To exercise reasonable diligence consistent herewith in the operation of said wells while the products therefrom can be obtained in paying quantities and not to unreasonably or unnecessarily suspend continuous operations except with the consent of the State. To carry on all operations hereunder in good workmanlike manner in accordance with approved methods, having due regard for the prevention of waste of oil and unreasonable waste of gas developed through the said wells of the Grantee, or the entrance of water through the said wells of the Grantee to the oil sands or oil bearing strata to the destruction or injury of the oil deposits, or future productive operations and the health and safety of workmen and employees; to plug securely, in the manner prescribed by any agency of the State having jurisdiction thereof, any of said wells of the Grantee, before abandoning the same so as to effectively stop the flow of water from the oil and gas bearing strata; to conduct all drilling and related productive operations hereunder subject to the inspection of authorized officials of

Exhibit 5-E—(Continued)

the State; to furnish to the State detailed drawings of all pipe lines in any manner attached to the said wells and to report changes or additions promptly; to gauge all oil, to measure all gas, whether dry or wet, in accordance with the rules and regulations now or which may hereafter be promulgated by the State, provided, the State shall have, at any time, the right to gauge all oil and measure all gas, and in the event of a disagreement between the State and the Grantee concerning the quality and quantity of the oil and gas so gauged or measured, the burden to establish the incorrectness of such gauging and measement shall rest upon the Grantee, and the Grantee is hereby given the right to establish, by proper court proceedings, the correct quality and quantity of such oil and gas so gauged and measured; to carry out at the expense of the Grantee all reasonable orders and requirements of the State relative to prevention of unreasonable waste and preservation of the property and the health and safety of workmen, and on failure so to do the State, through its agent or agents, shall have the right to enter on the uplands of Grantee, and, with facilities, tools, equipment and supplies of the Grantee, to repair or prevent such unreasonable waste at Grantee's cost; to abide by and conform to the rules and regulations in force at the time this agreement is executed, covering matters referred to in this paragraph, and to comply with such reasonable rules and regulations as may from time to time be issued by the State; or any other

Exhibit 5-E—(Continued)

agency of the State having jurisdiction therein; provided, however, that the Grantee shall not be responsible for delay or casualties occasioned by a cause beyond the control of the Grantee.

(j) That the State shall have the right to restrict by appropriate rules and regulations the spacing of wells and the rate of drilling and production of such wells so as to prevent the waste of oil and gas and promote the maximum economic recovery of oil and gas from, and the conservation of reservoir energy in, each zone or separate underground source of supply of oil or gas covered in whole or in part by this agreement, and further that the State may issue rules and regulations which may be amended from time to time to effectuate the purpose of this subsection and in connection therewith restrict the rate of production from any such zone or separate underground source of supply to that provided by Federal or State laws or rules or regulations thereunder, or by any reasonable conservation or curtailment plan ordered by the Commission or agreed to by a majority of the total production from any such zone or underground source of supply.

(k) That operations shall be conducted in such manner to prevent pollution and contamination of the ocean and tidelands and all impairment of and interference with bathing, fishing or navigation in the waters of the ocean adjacent to the uplands, and no oil, tar, residuary products of oil, or any refuse of any kind from any well or works of the

Exhibit 5-E—(Continued)

Grantee shall be permitted to be deposited on or pass into the waters of the ocean adjacent to the littoral lands or uplands.

(l) That each well drilled pursuant to the terms of this agreement shall be slant drilled from the uplands to and into the subsurface of the State lands. Derricks, machinery, and any and all other surface structures, equipment and appliances shall be located only upon the uplands and all surface operations shall be conducted therefrom.

(m) To assume and does hereby assume all liability for personal injuries and property damage resulting from the maintenance and operations of the wells of the Grantee and shall at all times hold the State free and harmless from any liability of the State of California, its officers, agents and employees on account of any negligent maintenance or operations on the part of the Grantee and the officers, agents and employees of the Grantee.

(n) Not to assign, transfer, or sublet to any person, association of persons, or corporation, who does not possess the qualifications provided in the Act; and not to assign, transfer or sublet to any other person, association of persons, or corporation without the prior consent in writing of the Commission; should the Grantee at any time during the term hereof be adjudged a bankrupt, either upon Grantee's voluntary petition in bankruptcy, or upon the involuntary petition of Grantee's creditors, or any of them, or should an attachment be levied and permitted to remain for an unreasonable length

Exhibit 5-E—(Continued)

of time upon or against the interest, rights or privileges of Grantee in or to any oil, gas or other hydrocarbon substances produced from any well or wells drilled by Grantee upon said lands, then all of the interests, rights, and privileges of Grantee in and to all oil, gas or other hydrocarbon substances produced and saved from the State lands by reason of Grantee's operations thereon, shall immediately cease, terminate and end, and in such event the State shall have, and Grantee, by the acceptance thereof, hereby gives the State, the right, option and privilege to cancel and terminate this agreement and all of the terms and provisions granted hereby, and all of the rights and privileges of Grantee in and to or upon the State lands, and in and to any oil, gas or other hydrocarbon substances produced and saved from the State lands by reason of Grantee's operations thereon, and all of Grantee's rights and privileges granted by this Agreement shall immediately cease and terminate and end upon the State so exercising its option in writing.

(o) To pay to the State the State's royalty share of any bonus received by the Grantee from the sale of any oil, gas or other hydrocarbon substances produced hereunder.

Section 3. The State expressly reserves:

(a) The right to grant easements or crossings in, upon and under the State lands, and nothing herein contained shall be construed as limiting the powers of the State of California to lease, convey,

Exhibit 5-E—(Continued)

or otherwise transfer or encumber, during the life of this agreement, the State lands for any purpose whatsoever not inconsistent or incompatible with the rights or privileges granted in this agreement to the Grantee; and further there is hereby specifically reserved from the operations under this agreement any and all rights and privileges heretofore granted by the State of California, as set forth in those Agreements for Easements Nos. 278, 279, 281, 282, 284, 286, 318, 336, 338 and 340; Huntington Beach, now on file with the State.

(b) The right to take its royalty oil, natural gasoline or dry gas in kind by giving notice of thirty (30) days to the Grantee of the State's intention so to do, and upon such election the State shall continue to take its said royalty oil, dry gas or natural gasoline (as the case may be) in kind for a period of six months from the time it commences to take such royalty oil, dry gas or natural gasoline (as the case may be) in kind, and thereafter for like periods of six (6) months unless the State shall at least thirty (30) days prior to the end of any such six (6) months period, notify the Grantee in writing of the State's election to cease taking its royalty oil, dry gas or natural gasoline (as the case may be) in kind, and to take the same in money.

Section 4. The State or the Grantee shall have the right to use any or all of the surplus gas of the Grantee for the purpose of repressuring the field of which the State lands are a part; and the State,

Exhibit 5-E—(Continued)

at its option, shall be entitled to take, at no expense to the Grantee, and without payment of compensation to the Grantee therefor, for the use of the State of California, all remaining surplus gas, which cannot be marketed by the Grantee at a reasonable price.

Section 5. That the Grantee may use oil or gas produced from the wells upon the State lands, or gas received currently in exchange for such gas so produced, for fuel purposes for necessary operations of the wells in State lands, for the drilling of new wells into the State lands, for re-circulation of any of the wells, or for repressuring the oil sand or sands from which any such well may be producing, even though such gas is injected into such sand through another well the bottom of which is in lands of the State of California, free from any royalty charges thereon.

Section 6. If and when it should become necessary to dehydrate or clean the oil produced from wells drilled into the State lands, the Grantee shall be entitled to compensation from the State of California of actual cost but not to exceed 2½c per barrel of net royalty oil so dehydrated or cleaned, or at such other rate per barrel as the parties hereto may mutually agree.

Section 7. After having been reduced to possession, the possession by the Grantee of the State's royalty portion of oil, gas and gasoline shall be as trustee for the State until full settlement for the royalty interests to the State have been made. Gran-

Exhibit 5-E—(Continued)

tee shall be empowered to sell and convey good title to the full amount of the State's royalty oil, gas and gasoline produced and saved if and when such sales have been approved in writing as herein provided.

Section 8. The Grantee may run all oil produced from the State lands to central storage tanks located either upon the uplands or other lands in the vicinity, from which said oil may be run to pipe line, after having been measured and tested and net volume computed, and gravity determined. Grantee may run such portion of the oil produced from the State lands which may require dehydration or cleaning to a central dehydration or cleaning plant and after cleaning and dehydration may run such oil to said central storage tanks.

Grantee shall measure separately by proper devices the oil produced from each of said wells, and at approximately regular intervals, at least once in each week of seven days, Grantee shall take samples and make tests of the oil produced from each of said wells to determine the net volume thereof. Such measurements and tests shall be used as a basis for allocating to each of said individual wells the net oil run to pipe line from said central storage tanks.

The Grantee shall meter all gas transported from the State lands and such meter readings, together with analysis of the gasoline content of said gas, made at approximately regular intervals at least

Exhibit 5-E—(Continued)

once in each month shall furnish the basis for computation of the amount of gasoline and residue gas deemed to have been extracted and saved from gas produced.

Section 9. The Grantee, at any time after drilling offset wells required to be drilled under this agreement may quitclaim this agreement as to all of the State lands embraced herein or as to any part or parts thereof, and in the event of a partial quitclaim, Grantee's obligations hereunder as to the number of wells (other than offset wells) to be drilled shall be reduced proportionately; provided however, that Grantee shall be obligated to make payment of all rents, royalties and other obligations due and payable to the State accrued to the date of such quitclaim; and further, provided, however, that in the event Grantee quitclaims a portion of the State lands such portion quitclaimed shall be in a compact form and not less than ten (10) acres; and further, provided, that the Grantee at the request of the State shall grant to any lessee or subsequent grantee of such quitclaimed area, upon such terms and conditions as the State may prescribe, a right to the free use with Grantee of rights of way, easements, or other interests in the State lands acquired by this agreement, as may be necessary or convenient in connection with the operations in such quitclaimed area under a lease or subsequent easement.

Section 10. The obligations of the Grantee hereunder shall be suspended while the Grantee is pre-

Exhibit 5-E—(Continued)

vented or hindered from complying therewith in part or in whole by strikes, lockouts, acts of God, laws, rules and regulations of any Federal, State, Municipal or other governmental agency, or other matters beyond the control of Grantee, whether similar to the matters herein specifically enumerated or not.

Section 11. This agreement may be terminated, and any of the provisions hereof may be modified or amended, upon the mutual consent of the parties hereto.

Section 12. All notices herein provided to be given or which may be given by either party to the other shall be deemed to have been fully given when made in writing and deposited in the United States mail, registered and postage prepaid, and addressed as follows:

(To the State)
State Lands Commission
Department of Finance
State Building
Los Angeles, California,
and

(To the Grantee)
P. O. Box No. 810,
Long Beach, California.

The addresses to which the notices shall or may be mailed, as aforesaid, to either party, shall or may be changed by written notice given by such party to the other as hereinabove provided; but nothing

Exhibit 5-E—(Continued)

herein contained shall preclude the giving of any such notice by personal service.

Section 13. If the Grantee shall fail to comply with the provisions of the Act so far as applicable or make default in the performance or observance of any of the terms, covenants and stipulations hereof, or of the rules and regulations of the State now promulgated, and all reasonable rules and regulations which may hereafter be promulgated, and such default shall continue for the period of thirty (30) days after written notice thereof to the Grantee, and no steps shall have been taken within that time, in good faith, to remedy said default, then the State may enter upon the premises of the Grantee and take possession of the same and all facilities, tools, equipment and supplies for the purpose of operating said wells of the Grantee until such time as all money defaults of the Grantee to the State have been fully satisfied, or if such default cannot be satisfied by the payment of money, then the State shall have the right and power to cancel this agreement or to close said well or wells which are not being conducted or operated in the manner prescribed by the provisions of this agreement, the rules and regulations of the State now promulgated, and reasonable rules and regulations of the State which may be hereafter promulgated; but this provision shall not be construed to prevent the exercise by the State of any legal or equitable remedy which the State might otherwise effect. The waiver of or failure of the State

Exhibit 5-E—(Continued)

to act upon any particular cause of forfeiture shall not prevent the cancellation and forfeiture of this agreement for any other cause of forfeiture or for the same cause occurring another time.

Section 14. It is further covenanted and agreed that each obligation herein shall extend to and be binding upon, and every benefit hereto shall inure to, the heirs, executors, administrators, successors and assigns of the respective parties hereto. Singular shall include the plural whenever applicable and the neuter genter shall include the feminine and masculine, and vice versa, whenever used in this agreement.

In Witness Whereof, The parties hereto have executed, or caused to be executed, this agreement the date and year first above written.

STATE LANDS COMMISSION of the STATE OF CALIFORNIA, Party of the First Part.

/s/ By WEBB SHADLE,
Attorney, Division of State Lands.

SOUTHWEST EXPLORATION COMPANY,
Party of the Second Part.

/s/ By E. J. SIEPE,
President.

/s/ By CHAS. M. JOHNSON,
Secretary.

Exhibit 5-E—(Continued)

EXHIBIT "A" (For entire tract)

Grantee shall commence drilling operations for the drilling of two wells within thirty (30) days from and after the date of this agreement, and shall thereafter continuously operate not less than two drilling outfits until Grantee has offset certain wells now drilled on the uplands known as the Pacific Electric Right of Way, being the wells of Standard Oil Company of California and known as "P.E." wells numbered "17", "16", "19", "20", "21", "22", "23", "24", "25", "26", "2", and also Standard Oil Company Bolsa well numbered "31"; each offset well shall be so drilled that all of the perforated or producing portion thereof shall be located less than 350 feet seaward from the ordinary high water mark of the Pacific Ocean. The perforated or producing portion of each offset well shall be so located as to reasonably offset each of said wells herein required to be offset by Grantee, and in all cases the perforated or producing portion of each such offset well shall be located in such "staggered" position that there shall be one well within each strip bounded by straight lines drawn at right angles to the line of said ordinary high water mark through the surface location of each of the upland wells of the Standard Oil Company of California above described. In the event Grantee does not elect to drill a well to offset the now existing well of Standard Oil Company of California known

Exhibit 5-E—(Continued)

as well numbered Bolsa "31", or in the event said Bolsa "31", should be abandoned, Grantee may quitclaim the offset location thereto and be relieved of its obligation with reference thereto in accordance with provisions governing quitclaim contained in this agreement.

After Grantee has completed the drilling of all offset wells herein provided to be drilled, it shall continue drilling (subject to the right of quitclaiming as provided in this agreement) with at least two drilling outfits (commencing its first well at the easterly side of the State lands) until Grantee has drilled into the State lands a total of eighteen (18) wells, including offset wells. Thereafter, Grantee shall continuously operate at least one drilling outfit until Grantee has drilled into the State lands a total number of wells equal to the nearest whole number obtained by dividing the total acreage of the State lands herein described by 10 (10).

The Grantee shall, however, be entitled to drill as many additional wells as Grantee desires.

Each offset well drilled pursuant to the within requirements shall be drilled so that it shall be bottomed in and produce from the same producing horizon as the well being thereby offset.

In the event additional wells are drilled upon and bottomed within the upland strip lying between the southwesterly boundary of Ocean Avenue and the line of the ordinary high water mark of the

Exhibit 5-E—(Continued)

~~Pacific Ocean, or within a strip~~ 175 feet wide along the northeasterly side of Ocean Avenue, provided no well has previously been drilled adjacent thereto southwesterly of Ocean Avenue, or in the event wells drilled from any other surface location are bottomed under said upland strips; and such well produces oil and gas in commercial quantities, then the next well to be drilled hereunder by Grantee shall be located and drilled so as to reasonably offset any such additional well so drilled or bottomed.

In the event, at any time, should any well drilled upon or bottomed within either of the two upland strips herein described be drilled to a deeper or plugged to a shallower separate and distinct producing oil zone or zones, and such well produces oil and gas in commercial quantities, Grantee shall within thirty (30) days thereafter commence operations for the drilling, deepening, or recompleting of a well to such deeper or shallower zone to offset such deepened or recompleted well and shall thereafter so offset each such deepened or recompleted well so drilled or bottomed. Grantee shall have and is hereby given the right to drill as many wells to any such deeper or shallower zone or zones (in addition to offset wells) as Grantee may elect.

The term "drilling operations" as used herein is hereby defined to be the construction of a derrick and other necessary structures for the drilling of an oil or gas well and the penetration of the ground with a drilling bit.

Exhibit 5-E—(Continued)

EXHIBIT "B"

The oil royalty which the Grantee shall pay to the State shall be according to the following formula:

$$R = \frac{P - .36.67}{2.5 + .016667P \times 1.1}$$

where R is the royalty rate in per cent applicable to the total value of the production of oil from each well during the month, and P is the average daily production of the well, determined by dividing the total production for the month by the total number of production days of twenty-four hours each;

provided, however, the Grantee shall pay at all times a minimum royalty of twelve and one-half (12½) per cent upon such average daily production.

Instructions to Bidder

The last term of the above equation shall be inserted by the bidder to establish the oil royalty which the bidder shall pay to the State.

Endorsement by Uplands Owner

The owner or owners of real property described in this agreement as the "uplands" hereby acknowledge that the Grantee named in this agreement has been granted all necessary rights-of-way and easements, in and through the uplands necessary for the performance upon the part of the Grantee of the covenants, and the observance upon

Exhibit 5-E—(Continued)

the part of the Grantee of the conditions, herein set forth, and the said owner or owners hereby consent to all operations upon the uplands specified and contemplated by the provisions of this agreement.

Huntington Beach Company executes the foregoing for itself and to the extent of its right, title and interest in said uplands.

HUNTINGTON BEACH COMPANY

/s/ By [Illegible]
Vice President.

/s/ By G. M. FOSTER,
Assistant Secretary.

Pacific Electric Railway Company executes the foregoing for itself and to the extent of its right, title and interest in said uplands.

PACIFIC ELECTRIC RAILWAY COMPANY

/s/ By A. A. SMITH,
President,

/s/ By [Illegible], Secretary.

Pacific Electric Land Company executes the foregoing for itself and to the extent of its right, title and interest in said uplands.

PACIFIC ELECTRIC LAND COMPANY

/s/ By A. E. SMITH,
President.

/s/ By [Illegible], Secretary.

Exhibit 5-E—(Continued)

Bolsa Land Company executes the foregoing for itself and to the extent of its right, title and interest in said uplands.

BOLSA LAND COMPANY
/s/ By T. M. KELLER, Pres.
/s/ By ROBERT N. FRIDE, Secretary.

Bolsa Chica Gun Club executes the foregoing for itself and to the extent of its right, title and interest in said uplands.

BOLSA CHICA GUN CLUB
/s/ By [Illegible], V. Pres.
/s/ By JAMES P. CAGE, Secy.

Standard Oil Company of California executes the foregoing for itself and to the extent of its right, title and interest in said uplands.

STANDARD OIL COMPANY
OF CALIFORNIA
/s/ By [Illegible],
Vice President.
/s/ By LEE LAIRD,
Assistant Secretary.

EXHIBIT 8-H

This Agreement, dated the 25th day of August, 1938, by and between Huntington Beach Company, a corporation, Pacific Electric Railway Company, a corporation, Pacific Electric Land Company, a corporation, and Standard Oil Company of California, a corporation, parties of the first part, herein collectively referred to as "Permittors",

Exhibit 8-H—(Continued)

and Southwest Exploration Company, a corporation, party of the second part, herein referred to as "Permittee",

Witnesseth:

Whereas, by a certain agreement between the parties hereto, dated the 25th day of August, 1938, a copy of which is hereto attached, marked "Exhibit 1", and by this reference made a part hereof, Permittors gave to Permittee, its successors and assigns, upon the terms and conditions therein provided, certain easements, rights and rights-of-way therein specifically set forth, over, on and through certain lands situate in the County of Orange, State of California, described in said agreement marked "Exhibit 1" and therein and hereinafter referred to as "uplands", for the conduct of Permittee's operations under that certain Agreement for Easement No. 392, therein and hereinafter referred to as "State Easement", a copy of which is attached to "Exhibit 1" and marked in "Exhibit 1" as "Exhibit A" and by this reference made a part hereof, for the extraction of oil, gas and other hydrocarbon substances from the lands described in said State Easement comprising approximately eight hundred thirty-five (835) acres and therein and hereinafter referred to as "State lands"; and

Whereas, the parties hereto desire that certain terms, conditions, limitations, reservations, and restrictions, in addition to the terms and conditions set forth in said agreement marked "Exhibit 1", shall apply to the exercise by Permittee of the

Exhibit 8-H—(Continued)

easement, rights and rights of way thereby given to Permittee:

Now, Therefore, in consideration of the premises and of the mutual covenants and agreements hereinafter set forth, the parties hereto do hereby agree as follows:

1. The surface location and the subsurface course through said uplands, of each well to be drilled by Permittee through said uplands pursuant to said State Easement shall be mutually agreed upon by said Standard Oil Company of California, hereinafter referred to as "Standard", and Permittee, and Standard's written approval thereof shall be obtained, prior to the commencement of Permittee's operations upon such well.

2. Permittee, in the drilling of each well through said uplands pursuant to said State Easement, shall adhere and conform to the subsurface course and location through said uplands mutually agreed upon as hereinabove provided; and no drilling, redrilling, deepening, or other work which would change the subsurface course or location of said well through said uplands shall be undertaken by Permittee until such change shall have been mutually agreed upon with Standard and until Standard's written approval thereof shall have been obtained.

3. The surface location for all pipe lines, telephone and telegraph lines, derricks, tanks, machinery, buildings, and other structures and surface facilities to be erected by Permittee upon

Exhibit 8-H—(Continued)

said uplands (exclusive, however, of that portion of said uplands which is comprised of Ocean Avenue and of that portion of said uplands which is comprised of the sixty-foot operating strip of Pacific Electric Railway Company lying immediately adjacent to the southwesterly line of Ocean Avenue and which is referred to in Paragraph 2 of said agreement marked "Exhibit 1"), shall be mutually agreed upon by Standard and Permittee, and Standard's written approval of such surface locations shall be obtained prior to the installation of any such lines, structures or facilities.

4. In the drilling and construction of all wells drilled by Permittee through said uplands pursuant to said State Easement, Permittee shall use and install therein materials and equipment of good quality and condition and all of said wells shall be drilled by Permittee in the best workmanlike manner in accordance with good oil field practice; and all water sands encountered therein shall be effectively and in a proper manner plugged off. All drilling and other operations of Permittee hereunder and pursuant to the provisions of said State Easement shall at all times be conducted by Permittee in a good and workmanlike manner and so as to prevent and avoid danger of injury or damage therefrom to the wells and property of Permittors and each of them.

5. Permittee shall, upon the written request of Standard, or Pacific Electric Railway Company or both, furnish copies of logs, records of well cores;

Exhibit 8-H—(Continued)

electrical logs or surveys, and water entrance surveys, plats and surveys showing locations and courses with respect to each and every well drilled by Permittee through said uplands pursuant to said State Easement, together with complete information as to the location, course, mechanical condition, pressures, water shut-offs, oil, gas and water production, perforations, condition, fluid levels, depth pressures, size of pump, length and speed of stroke, and other facts relative thereto, to either or both parties requesting the same. If the data and information so furnished by Permittee are incorrect or for any reason insufficient to establish the location, course, or condition of any of said wells, Permittee will, upon being notified of that fact, promptly furnish such additional information as may be required by Standard or Pacific Electric Railway Company, and if Permittee fails to furnish the data and information so required, Standard or Pacific Electric Railway Company shall have the right to make such examination as may be necessary to obtain the desired information. Standard, or Pacific Electric Railway Company, at all reasonable times, shall be entitled to inspect all operations of the Permittee upon said uplands and under said State Easement, and shall have the right of access to any well drilled by Permittee through said uplands pursuant to the provision of said State Easement and to all records and survey data pertaining thereto as to the history, location, course, mechanical condition, equip-

Exhibit 8-H—(Continued)

ment, pressures, water shut-offs, oil production, perforations and condition of said well.

6. That if, as and when any of Permittee's wells are abandoned, Permittee shall promply abandon the same in accordance with regulations of the State of California, Department of Natural Resources, Division of Oil and Gas, and in addition thereto, shall promptly and effectively plug with cement in a good and workmanlike manner such portion or portions thereof and take such reasonable precautions and protective measures with reference thereto, as may, in the judgment of Standard, be necessary to prevent injury or damage to, or interference with, the property or wells of Standard.

7. Permittee shall comply with all laws of the State of California and all rules and regulations of any agency of the State of California having jurisdiction therein, and all laws of the United States of America and all rules and regulations of any agency of the United States of America having jurisdiction therein, relating to the drilling, maintenance and operation of oil and gas wells drilled through said uplands pursuant to said State Easement and the production of oil and gas therefrom.

8. Subject to the provisions of said State Easement with respect thereto, Permittee shall comply with any reasonable conservation or curtailment program or programs which may at any time and from time to time affect the production of oil and gas from wells to be drilled by Permittee through said uplands pursuant to said State Easement.

Exhibit 8-H—(Continued)

which program or programs are mutually agreed to by the producers of a majority of the total production of oil and gas from each zone or separate underground source of supply in which Permittee is authorized to bottom its wells pursuant to said State Easement. Permittee shall conduct all producing operations in wells drilled through said uplands pursuant to said State Easement in accordance with good oil field engineering practice.

9. The rights hereby granted are personal to the Permittee and shall not be assigned in whole or in part without the written consent of Permittors. Subject to all of the terms and conditions hereof, this agreement shall be binding upon the successors and assigns of the parties hereto.

10. Any and all reasonable costs or expense incurred by Permittors in enforcing or effectuating this agreement will be reimbursed by Permittee on demand.

11. Permittors expressly reserve unto themselves, their present and future subsidiaries, and to their successors and assigns, the right to give easements or subsurface well crossings in, upon and under said uplands, together with right of ways through, over, under, upon and across said uplands for roads, power lines, telephone and telegraph lines, pipe lines and other instrumentalities, whether similar to those herein expressly enumerated or not; provided, however, that Permittors shall not give such easements or subsurface well crossings in, upon and under said uplands for the

Exhibit 8-H—(Continued)

purpose of drilling wells into any portion of the lands described in said State Easement lying below the ordinary high water mark, in which and so long as, Permittee shall retain the interest therein granted it by said State Easement.

12. Permittee shall in all respects exercise the surface privileges hereby granted in such manner as to interfere as little as practicable with operations of Permittors, and each of them. No building, rig or other structure owned by Permittors shall be removed or relocated by Permittee without the written consent of the particular Permittor owning same.

13. The rights herein given Permittee are subject to all existing agreements and leases between Standard and any of the other Permittors, together with any present and future renewals, extensions or modifications thereof, and are subject also to the reservations set forth in said agreements and leases as so renewed, extended or modified. The rights herein given to the Permittee are also subject to all existing subsurface crossing permits heretofore given by Permittors, or any of them, for wells of others through said uplands, and also to all other existing grants, conveyances, leases, agreements, reservations, right of ways, easements, permits, licenses and other privileges affecting said uplands.

14. Any notice, information or data to be given said Huntington Beach Company hereunder shall be valid if mailed by registered mail, postage pre-

Exhibit 8-H—(Continued)

paid, to Huntington Beach Company, at 225 Bush Street, San Francisco, California.

Any notice, information or data to be given said Pacific Electric Railway Company hereunder shall be valid if mailed by registered mail, postage prepaid, to Pacific Electric Railway Company, at Pacific Electric Bldg., Los Angeles, California.

Any notice, information or data to be given said Pacific Electric Land Company hereunder shall be valid if mailed by registered mail, postage prepaid, to Pacific Electric Land Company, at Pacific Electric Bldg., Los Angeles, California.

Any notice, information or data to be given said Standard Oil Company of California hereunder shall be valid if mailed by registered mail, postage prepaid, to Standard Oil Company of California, at 225 Bush Street, San Francisco, California.

Any notice or other communication to be given by Permittors to Permittee shall be valid if mailed by registered mail, postage prepaid, to Permittee, at Long Beach, California.

In Witness Whereof, the Permittors and Permittee have caused this instrument to be executed in their respective corporate names by their respective authorized officers whose names are hereunto subscribed.

HUNTINGTON BEACH COMPANY

By R. C. STONE,
Vice President.

By G. M. LOST,
Assistant Secretary.

Exhibit S-H—(Continued)

PACIFIC ELECTRIC RAILWAY COMPANY

/s/ By A. E. SMITH,
President.

/s/ By [Illegible],
Secretary.

PACIFIC ELECTRIC LAND COMPANY

/s/ By A. E. SMITH,
President.

/s/ By [Illegible],
Secretary.

STANDARD OIL COMPANY OF CALIFORNIA

/s/ By [Illegible],
Vice President.

/s/ By LEE LAIRD,
Assistant Secretary.
Permittors.

SOUTHWEST EXPLORATION COMPANY

/s/ By E. J. SIEPE,
President.

/s/ By CHAS. M. JOHNSON,
Secretary.
Permittee.

EXHIBIT 91

This Agreement, dated the 27th day of September, 1938, by and between Southwest Exploration Company, a corporation, Party of the First Part, hereinafter referred to as "Southwest", and Pacific Electric Railway Company, a corporation, and Pacific Electric Land Company, a corporation, hereinafter collectively referred to as "Pacific Electric", and Huntington Beach Company, a California corporation. Said Pacific Electric and Huntington Beach Company are hereinafter referred to as "Second Parties."

Witnesseth:

That, Whereas, by two agreements dated the 25th day of August, 1938, Second Parties and others gave Southwest, its successors and assigns, upon the terms and conditions therein provided, certain easements, rights, and rights of way therein specifically set forth, over and through certain uplands, provided Southwest's application to the State of California for a State Easement for the extraction of oil, gas, and other hydrocarbon substances from certain State lands was granted; and

Whereas, the said application was granted by the State of California, and Southwest is the owner and holder of an interest under that certain Agreement for Easement dated the 26th day of September, 1938, between the State of California, through its State Lands Commission, and Southwest, as Grantee, hereinafter referred to as "State Easement," being Agreement for Easement No. 392, and by this reference made a part hereof, whereby

Exhibit 9-I—(Continued)

the State of California granted to Southwest an easement through, in, and under the lands described in said State Easement, comprising approximately 835 acres, and therein referred to as "State Lands," together with the right to drain, take, receive, extract, remove, and produce from said State Lands, oil, gas, and other hydrocarbon substances through certain wells to be drilled, operated, and maintained by Southwest in the manner provided in said State Easement, the tops of which such wells shall be located on the lands described and referred to in said State Easement as "uplands"; and

Whereas, it is the desire and intention of the parties hereto to provide a manner of computation and distribution of rental for the rights and privileges given by Second Parties and others to Southwest in said agreements dated the 25th day of August, 1938:

Now, Therefore, for a good and valuable consideration, the receipt of which by Southwest is hereby acknowledged, it is agreed as follows:

1. The lands hereinafter in this agreement referred to are described as follows:

That certain area of land situate in the County of Orange, State of California, being a portion of those certain lands referred to as "State Lands," belonging to the State of California in "Exhibit A" of agreements dated August 25, 1938, between Huntington Beach Company, a corporation, Pacific Electric Land Company, a corporation, and Standard Oil Company of California, a corpora

Exhibit 9-P—(Continued)

tion, parties of the first part, collectively referred to as "Permittors," and Southwest Exploration Company, a corporation, party of the second part, referred to as "Permittee," more particularly described as follows:

Beginning at the point of intersection of the ordinary high water mark of the Pacific Ocean with the southwesterly prolongation of the center line of Twenty-third Street in the City of Huntington Beach, as said center line is shown on a map entitled "Resurvey of Part of Section 34, Township 5 South, Range 11 West, and Part of Sections 3, 4, and 10 of Township 6 South, Range 11 West, S.B.B.&M., as per Stearns Rancho Company's Sectionized Survey by Captain T. C. Healey, Surveyor, Surveyed by L. G. B. McDowell, Field Work Completed September 15, 1927," filed at page 28 of Book 3 of Maps in the office of the Recorder of the County of Orange; thence from said point of beginning,

Northwesterly along the ordinary high water mark of the Pacific Ocean to its intersection with the north and south center line of Section 4, Township 6 South, Range 11 West, S.B.B.&M.; thence

South 40° 36' West 5280 feet to the southwesterly boundary of said State Lands; thence

Southeasterly in a direct line to a point South 40° 36' West 5280 feet from the point of beginning; thence

North 40° 36' East 5280 feet to said point of beginning;

Exhibit 9-I—(Continued)

Being a portion of the lands described in State Easement referred to above.

2. The term "net profits" as used in this agreement and as applied at any particular time, shall mean the amount by which the "gross proceeds," as hereinafter defined, derived by Southwest from its operations on or in said herein described lands, up to that time, shall exceed the "chargeable expenses," as hereinafter defined, paid and incurred by Southwest up to the same time in connection with such operations.

3. The term "gross proceeds" as used in this agreement shall mean and include:

(a) The "sale value", as hereinafter defined, of all oil and other hydrocarbon substances (other than gas and gasoline) produced and saved by Southwest from said herein described lands, exclusive of royalty oil and of other hydrocarbon substances (other than gas and gasoline), delivered in kind to the State of California as its royalty share of such oil and other hydrocarbon substances;

(b) The sale value of one hundred per cent (100%) of all gas produced and saved and sold by Southwest from said herein described lands, including the sale value (computed at the same price at which gas is contemporaneously produced and sold from said herein described lands) of any gas retained by any processor under the provisions of any processing agreement which Southwest may enter into for the processing of gas produced from the herein described lands, exclusive, however, of any

Exhibit 9-I—(Continued)

royalty gas delivered in kind to the State of California;

(c) The "sale value," as hereinafter defined, of fifty per cent (50%) of all gasoline extracted from gas produced from said herein described lands, exclusive of royalty gasoline delivered in kind to the State of California as its royalty share of the gasoline extracted from gas;

(d) All sums received as rental for materials, supplies, equipment, or facilities, the cost of which has been included within "chargeable expenses" hereunder, rented to others during the term of said State Easement, together with the value of all of said materials, supplies, equipment, or facilities removed from the herein described lands or from said uplands for purposes other than rental, together with the then reasonable market value of all materials, supplies, equipment, or facilities remaining at the time of abandonment or termination of said State Easement, if used thereafter by Southwest, or if not so used, then the actual proceeds at the time of ultimate sale;

(e) The value of any benefits, refunds, credits, returns, or discounts received by Southwest because of its operations upon or in connection with herein described lands.

4. (a) The term "sale value" of all oil, asphaltum, and other hydrocarbon substances (other than gas and gasoline), as used herein, is hereby defined to mean the value thereof computed at the current price posted and paid therefor by Standard Oil

Exhibit 9-I—(Continued)

Company of California from time to time to producers generally for products of like character, gravity, and quality in the same vicinity.

(b) The term "sale value" of gasoline, as herein used, is hereby defined to mean the value thereof computed at the current prices paid therefor by Standard Oil Company of California, or any of its present or future subsidiaries, from time to time to producers generally for products of similar specifications, vapor pressure, and quality in the same vicinity.

5. The term "chargeable expenses," as used in this agreement, shall mean and include:

The entire cost and expense to Southwest of equipping, developing, and operating said herein described lands, and of drilling for, producing, cleaning, and transporting to shipping or stock tanks, including costs of delivering oil from Southwest's storage into pipe lines or other transportation facilities of purchaser, oil, gas, and other hydrocarbon substances from said herein described lands.

Without in any way limiting the generality of the foregoing, "chargeable expenses" shall include:

(a) All operating expenses which shall include the erection of structures for the drilling and operation of oil wells and the storing of oil (including foundations and all necessary production structures), the drilling, maintenance, pumping, cleaning out, repairing, deepening, and redrilling of all wells, together with the cleaning of oil, construc-

Exhibit 9-I—(Continued)

tion and maintenance of roads and other means of access of pipe and power lines of every character from time to time necessary, of transportation of every nature, payments of claims for damages (except such claims as are paid out of funds impounded under paragraph 5(d) hereof), costs of litigation, including attorneys' fees, caused by or resulting from operations under said State Easement to the extent applicable to the lands herein described, and, without limitation by reason of the specific recitals herein enumerated, any expenditures reasonably appropriate to the proper handling and development of the lands herein described, and of the oil and gas, or either of them, therefrom, and accounting, stenographic, and clerical help in connection with said operations. The charge made by Southwest for supervision and management shall not include any executive or office expenses other than those applicable to the conduct of operations on the lands herein described and incurred by Southwest in the conduct of its field office now located upon lands described in said agreements of August 25, 1938.

(b). To the extent applicable to the lands herein described, all taxes and other charges paid by Southwest; premiums on any and all bonds required; insurance of all kinds; and any court costs, reasonable attorneys' fees, and any other expenses as may be reasonably incurred for the protection or defense or continuance of the rights, title or interest of Southwest in and to the property herein

Exhibit 9-I—(Continued)

described as against claims of others. The taxes herein referred to may be prorated monthly over the twelve months of the taxable year, subject to correction when actually paid.

(c) To the extent applicable to the lands herein described, all sums, rentals, and royalties paid in money by Southwest to the State of California under the provisions of said State Easement, and all moneys and/or royalties paid by Southwest to the City of Huntington Beach required to be paid under the provisions of that certain agreement made as of the 3rd day of November, 1938, between Southwest, as party of the first part, and City of Huntington Beach, a municipal corporation, as party of the second part, reference to which is hereby made for further particulars.

(d) In the event actual pending claims exist for damages alleged to have been caused by the operations herein referred to, a reasonable sum as a reserve for the payment of such claims; provided that such reserve fund shall be deposited in a special account in a bank or trust company, and shall not be used except for payment of such claims; upon payment of such claims out of said reserve fund, any excess over said claims shall become a part of "gross proceeds."

It is understood and agreed that Southwest is presently operating only the properties herein described under the provisions of said State Easement, and has no office, branch or place of business other than upon the lands described in those said

Exhibit 9-I—(Continued)

agreements dated August 25, 1938, elsewhere herein referred to, and that "chargeable expenses" shall include all costs and charges incurred in the erection and maintenance of office buildings, warehouses, and other structures used in connection therewith and erected and maintained upon the lands described in said agreements of August 25, 1938. In the event Southwest should at any time engage in any other development work and/or business other than that specifically herein referred to, or shall establish other offices, then and in that event "chargeable expenses" shall not include any item of overhead, charge, or expense in connection with such other development work and/or business or other offices. In the event Southwest shall incur and pay any item or items of expense in connection with the drilling, development, or operation of said herein described lands and other lands, only such proportion of such item or items of expense as may be properly allocable to said herein described lands shall be included in "chargeable expenses" hereunder. Neither shall "chargeable expenses" include franchise, license, capital stock, income, profit, or other similar corporate taxes of Southwest.

6. Southwest shall have the free use of, and shall not be required to account to Second Parties for, any oil or gas produced from and used by Southwest in its operations pursuant to said State Easement on said herein described lands.

7. Southwest shall keep true and correct books of account showing the production of oil, gas, and

Exhibit 9-1—(Continued)

gasoline, and other hydrocarbon substances produced during each calendar month from wells drilled by Southwest pursuant to said State Easement, and shall also keep true and correct books, accounts, and records showing all other data necessary or proper for the settlement of accounts between the parties hereto and the proper adjustment of their rights under this agreement. Not later than the last day of each calendar month, Southwest shall deliver to Second Parties an itemized written statement showing in detail the production and the "gross proceeds" derived from its operations and the total amount of all "chargeable expenses" paid and incurred by Southwest up to the end of such preceding month; and thereafter not later than the end of such calendar month, Southwest shall deliver to Second Parties similar written statements showing the production and the "gross proceeds" derived and the total amount of "chargeable expenses" paid and incurred during the preceding month.

Said statement of "chargeable expenses" shall be in the same summarized form as Southwest shall prepare such statement for its own use.

8. Southwest shall pay to Second Parties as rental an amount equal to the following percentages of the "net profits":

17.75% to Huntington Beach Company,
1.576% to Pacific Electric Railway Company,
5.174% to Pacific Electric Land Company.

Exhibit A-I—(Continued)

Said rental payments shall be made on or before the 25th day of the month immediately following the time when "net profits" arise in the operations herein referred to. As between Pacific Electric Railway Company and Pacific Electric Land Company, the rental payments hereinabove in this paragraph referred to are determined by the proportion of acreage owned by each as to which said State Easement is granted; namely, Pacific Electric Railway Company, 23.35% thereof; Pacific Electric Land Company, 76.65% thereof, the same being 1.576 and 5.174%, respectively, of the "net profits" hereinabove defined and referred to in Paragraphs 2 and 8 hereof.

9. All rental payments to Huntington Beach Company hereunder shall be paid to Huntington Beach Company by Southwest's mailing or delivering check therefor to Huntington Beach Company at 225 Bush Street, San Francisco, California.

10. All rental payments to Pacific Electric hereunder shall be paid to Pacific Electric by Southwest by mailing or delivering in favor of each company, checks therefor to Pacific Electric at Pacific Electric Building, Los Angeles, California.

11. Second Parties, or any one of them, shall have the right to examine at all times the premises herein described and the work done, and in progress thereon, and the production therefrom, and shall also have the right to inspect the books and records kept by Southwest in relation to said property to ascertain the "gross proceeds" and

Exhibit 9-I—(Continued)

"chargeable expenses" herein referred to, and the production from said property and the amount shipped therefrom.

12. Southwest shall keep a record of installation of all pipe lines laid by Southwest on Second Parties' premises showing the location of such pipe lines, and give Second Parties, or any one of them, access to such record at all times, and upon the request of Second Parties, or any one of them, shall furnish a copy of such record.

13. It is understood and agreed that nothing herein shall add to, modify, or limit the privileges given to Southwest by Second Parties and others in those certain agreements dated August 25, 1938, or the rights given to Southwest under said State Easement, nor shall any default hereunder by Southwest cause a forfeiture of the rights or privileges given Southwest by Second Parties under said agreements of August 25, 1938.

14. All operations performed by Southwest in connection with the development and operation of said described lands shall be at the sole cost and expense of Southwest, and Second Parties shall not be chargeable with nor liable for any part thereof. None of the amounts paid to Second Parties hereunder shall be returned to Southwest should there be a subsequent loss in the development and operation of said lands, provided that if said State Easement and the privileges given Southwest under said agreements of August 25, 1938, and referred to herein, are terminated otherwise than as provided

Exhibit 9-I—(Continued)

therein and a loss results to Southwest therefrom, then each Second Party shall repay to Southwest the following percentages of such loss: as to Huntington Beach Company, 17.75%; as to Pacific Electric Land Company, 5.474%; and as to Pacific Electric Railway Company, 1.576%; provided that none of Second Parties shall be required to pay, in any event, more than has been received by such Second Party hereunder.

15. Second Parties shall have no right, title or interest in or to any machinery, rigs, pipes, casing or other property or improvements of whatsoever nature belonging to or furnished by Southwest in connection with the development and operation of said within described lands, and Southwest shall have the right to remove at any time, and from time to time, all machinery, rigs, pipes, casing, and other property and improvements belonging to or furnished by Southwest, provided that upon removal of any of said property, a proper accounting of the value thereof when removed shall be made as hereinabove provided.

16. Any notices or statements to be furnished to any party hereto shall be addressed to such party at its address, as follows:

Southwest Exploration Company, P. O. Box 270, Huntington Beach, California.

Huntington Beach Company, 225 Bush Street, San Francisco, California.

Exhibit 9-I—(Continued)

Pacific Electric Railway Company, Pacific Electric Building, 610 South Main Street, Los Angeles, California.

Pacific Electric Land Company, Pacific Electric Building, 610 South Main Street, Los Angeles, California.

17. The Second Parties hereby agree among themselves that neither the fact of the execution of this agreement nor anything contained herein shall in any way be deemed as an admission of any of said parties with respect to the right, title, or interest any or both may have in or to any property concerned herein, or in any manner whatsoever be deemed or used as evidence thereof, or as a basis for the construction thereof, or in any manner whatsoever, or at all, used, employed or taken as a basis for the definition of any such right, title, or interest of the Second Parties, or any of them.

18. Whenever reference is made herein to said State Easement, such reference shall be deemed to mean and include any and all extensions, modifications, or renewals thereof.

19. This agreement shall not be construed to give Second Parties any right, title or interest in said State Lands or in or under said State Easement, and said Southwest may, at any time, at its election, without any consent or participation by Second Parties, modify said State Easement or surrender, and terminate the same in accordance with the provisions thereof. In the event that Southwest shall as-

Exhibit 9-I—(Continued)

sign its interest in State Easement, such assignment shall be made subject to the assumption by the assignee thereunder of all of the obligations of Southwest under this agreement.

20. Southwest shall pay all taxes that may be levied against the improvements, plant, machinery, and personal property owned by it and located upon any part of Second Parties' premises, including oils and minerals that may be stored upon said property.

21. Each party hereto shall promptly notify all other parties hereto of any judicial proceedings brought to its attention and purporting to affect, or affecting, its position hereunder.

22. This agreement and the two said agreements of August 25, 1938, and any and all rights of Southwest in or to the property covered thereby, shall terminate upon the expiration of said Easement No. 392 or any renewals, extensions, or modifications thereof. Upon such termination, Southwest shall proceed diligently to remove any and all facilities which it may have placed upon said uplands and shall forthwith restore said uplands as nearly as possible to the condition in which said premises existed prior to the commencement of operations thereon by Southwest. Southwest shall immediately upon such termination pay to Second Parties whatever sums of money which may then be due them.

23. It is the express intention of the parties hereto not to create a partnership relationship.

24. This agreement shall inure to the benefit of,

Exhibit 9-I—(Continued)

and shall be binding upon, the parties hereto, their respective successors and assigns.

In witness whereof, the parties hereto have executed this agreement.

SOUTHWEST EXPLORATION COMPANY,

/s/ By H. J. MARCH,
President,

/s/ By H. N. GREEN,
Secretary.

PACIFIC ELECTRIC RAILWAY COMPANY,

/s/ By R. A. SMITH,
President,

/s/ By L. A. LOREE,
Secretary.

PACIFIC ELECTRIC LAND COMPANY,

/s/ By R. A. SMITH,
President,

/s/ By L. A. LOREE,
Secretary.

HUNTINGTON BEACH COMPANY,

/s/ By R. V. STONER,
Vice President,

/s/ By G. M. JOST,
Assistant Secretary.

Duplicate Original.

[Endorsed]: T.C.U.S. Filed July 9, 1951.

[Title of Tax Court and Cause.]

FINDINGS OF FACT AND OPINION

1. Petitioner was granted the drilling and development rights in certain submerged oil property by the State of California. Under the terms of such grant petitioner was required to drill certain offset wells. Upon completion thereof, petitioner was to continue uninterrupted drilling operations until a total of 83 wells were thus drilled. Held: The drilling of the wells during 1939 to 1943, inclusive, subsequent to the required number of offset wells was a part of the consideration for acquisition of the drilling rights from the State of California and as such the intangible drilling costs incident thereto are not deductible in accordance with the option contained in Regulations 111, Section 29.23 (m)-16.

2. Pursuant to the State Lands Act of 1938 all oil wells bottomed in the submerged oil deposits were required to be drilled from filled lands or slant drilled from littoral drill sites. The necessary drill sites and easements appertaining thereto were acquired from certain upland owners by petitioner for which is agreed to pay an amount equal to 24½ per cent of its net profit. Held: Petitioner was the sole recipient of an economic interest in the submerged oil deposits; no third parties thereafter acquired any such interest; the amounts paid by petitioner equal to 24½ per cent of its net profits were not so paid as rent or royalty on an economic interest in the oil and gas in place; and, therefore, petitioner is entitled to include such amounts in its gross in-

come subject to the statutory allowance for depletion.

Melvin D. Wilson, Esq., for the petitioner.

B. H. Neblett, Esq., for the respondent.

This proceeding involves corporate income, declared value excess-profits tax and excess profits tax, as follows:

	Income Tax	
Year	Deficiency Determined	Overpayment Claimed
1939	$32,114.88	
1940	31,271.85	
1941	5,470.28	
1942	34,075.82	
1943	46,767.42	$ 2,883.04
1944	31,822.17	17,828.29
1945	47,892.34	1,758.12
	Declared Value Excess-Profits Tax	
1939	$20,455.80	
1940	5,973.03	
1942	6,996.71	
1944	2,982.50	
1945	8,764.91	
	Excess Profits Tax	
1940	$24,545.60	
1941	54,525.59	$23,942.25
1942	81,158.14	31,379.00
1944	34,102.12	27,385.23
1945	22,219.31	51,088.51

Note: Briefs amicus curiae filed by W. J. McFarland, Esq., and E. D. Yeomans, Esq.

There are two questions presented in this case. One, involving the taxable years 1939 to 1942, inclusive, is concerned with the propriety of petitioner's deducting so-called intangible drilling costs incurred during those years in producing oil from submerged coastal lands on a portion of an operating grant from the State of California.

The second issue raises the question of whether petitioner may properly take a depletion deduction in the taxable years 1939 to 1945, inclusive, on an amount equal to 24½ per cent of its net income, which amount is paid to certain upland owners on and through whose properties petitioner had located "whipstock" wells for purposes of producing oil from the adjacent submerged lands.

The State of California has proposed additional franchise taxes against petitioner for the years 1939 to 1946, inclusive, based on adjustments of income similar to those set out in the deficiency letter herein. The State has requested, and obtained, from petitioner agreements waiving the statute of limitations for assessing such additional franchise taxes for the years 1939 to 1946, inclusive. Petitioner has filed protests against these additional franchise taxes.

The parties have stipulated that if petitioner prevails as to both of the foregoing issues, and if it is not entitled to deduct any franchise taxes not allowed in the deficiency letter, petitioner will be entitled to additional depletion deductions, as follows:

1941	$ 19,443.62
1942	96,189.89
1943	91,452.47
1944	218,032.38
1945	244,764.71

If petitioner prevails as to the second issue above, but not as to the first, it has been stipulated that then petitioner will be entitled to additional depletion deductions, as follows:

1941	$ 35,874.23
1942	96,189.89
1943	82,446.98
1944	218,032.38
1945	244,764.71

The parties have entered into agreements from time to time pursuant to section 276 (b), Internal Revenue Code, extending the period for the assessment of additional taxes for each of the years 1941 to 1945, inclusive. These agreements were executed within three years, respectively, from the time the returns to which they apply were filed by the taxpayer.

Respondent has filed an amendment to his amended answer in which he makes claim for any increased deficiency in petitioner's income tax that may result from our holdings herein.

Findings of Fact

Most of the facts have been stipulated. Oral stipulations made and the written stipulation filed with exhibits attached are adopted and made a part hereof.

Petitioner is a corporation organized under the laws of California on June 20, 1933: It was completely inactive until 1938. Its principal office and place of business is 811 West Seventh Street, Los Angeles, California. The petitioner filed its corporate income, declared value excess-profits tax and excess profits tax returns for the calendar years 1938 to 1945, inclusive, with the collector of internal revenue for the sixth district of California at Los Angeles, California. From its inception, petitioner has kept its books and filed its tax returns on the accrual basis.

Prior to 1938 the State of California permitted State lessees and oil operators to develop and operate submerged coastal oil deposits from piers, islands and barges. This practice resulted in waste petroleum products interfering with fishing and bathing along the beaches of southern California. In 1938 the State Legislature passed the State Lands Act of 1938 under which the State Lands Commission was appointed with power to lease the submerged lands in such manner as to prevent the oil operations from despoiling the beaches. From August 8 to 13, 1938, this Commission published a Notice of Intention to Receive Offers to enter into an agreement for extraction of oil and gas from an area of submerged lands situated off Huntington Beach, California. The area involved was approximately 835 acres and was the area which eventually was covered by State Easement No. 392.

Petitioner made a bid and submitted same on Au-

gust 30, 1938. With its letter transmitting the bid it filed a form of Agreement for State Easement, later identified as No. 392, and attached to this agreement was so-called "Exhibit A (for entire tract)" which constituted the drilling requirements. There was also attached thereto "Exhibit B" which set out the royalty which petitioner agreed to pay, as well as an endorsement by upland owners indicating that such owners had given petitioner authority to drill wells on their land and to run its wells through their property out under the ocean. Also attached to the transmittal letter were the following:

(a) Permit agreement executed with upland owners.

(b) Cashier's check for $15,000.00 payable to the Treasurer of the State of California.

(c) Certified copies of resolutions authorizing petitioner's officers to execute the agreement for the foregoing permit and the agreement for Easement No. 392.

(d) Certificate of Ownership showing that all petitioner's stockholders were residents of the State of California.

In addition, petitioner furnished the $25,000 bond required by the Agreement for State Easement No. 392.

Petitioner's bid was accepted and it entered into the Agreement for State Easement No. 392 with the State Lands Commission on September 26, 1938. The granting clause reads, in part, as follows:

Section 1. That the State, in consideration of the royalty to be paid, the covenants to be performed, and the conditions to be observed by the Grantee, as herein set forth, does hereby grant to the Grantee an exclusive easement appurtenant to the lands of the Grantee hereinafter described, through, in and under lands of the State of California (hereinafter referred to as the State lands), hereinafter more particularly described, together with the exclusive right to drain, take, receive, extract, remove and produce from the State lands oil, gas, and other hydrocarbon substances through certain oil wells to be drilled, operated and maintained by the Grantee in the manner hereinafter provided, the tops of which such wells shall be located upon that portion of those certain littoral lands and uplands lying within a prolongation or projection northerly of the sidelines of the hereinafter described parcel of state lands * * *.

The Agreement then continues, in part, as follows:

Section 2. The Grantee in consideration of the foregoing hereby agrees:

(a) To furnish a bond in favor of the State of California, and approved by the State in the penal sum of $25,000.00 to guarantee the faithful performance by the Grantee of the terms, covenants and conditions of this agreement and of the provisions of the Act.

(b) To commence operations for the drilling of wells into the State lands, and to thereafter con-

tinue with such drilling in accordance with the drilling program, attached hereto, marked Exhibit "A", and by reference made a part hereof.

(c) To pay to the State of California a royalty in accordance with the formula, marked Exhibit "B", attached hereto, and by reference made a part hereof, on the oil produced and saved from each well producing from the State lands or on demand the State's percentage of oil produced in accordance with said Exhibit "B", * * *

* * * * *.

(d) To pay to the State annually in advance as rental the sum of one (1) dollar per acre for each acre of State lands herein described, which rental shall be credited against the royalties, if any, as they accrue for the year for which such rental is paid.

Beginning in 1923, Standard Oil Company of California drilled wells on the uplands, which petitioner was required to use in connection with the operation of its State lease, and has produced oil from such uplands ever since. The drilling program contained in the Exhibit "A", referred to above, called for petitioner to drill 12 wells near the shore to offset a like number of existing wells of the Standard Oil Company. By virtue of subsequent amendments to this original agreement executed on March 22, 1939, and August 12, 1943, and under certain conditions set forth therein, petitioner was temporarily relieved of its immediate obligation to drill the twelfth well. Petitioner has agreed to the capitalization of the intangible drilling costs of the 11

wells so drilled by it as being its principal acquisition cost of obtaining the lease.

The drilling program further provides, in part, that:

> After Grantee [petitioner] has completed the drilling of all offset wells herein provided to be drilled, it shall continue drilling (subject to the right of quitclaiming as provided in this agreement) with at least two drilling outfits (commencing its first well at the easterly side of the State lands) until Grantee has drilled into the State lands a total of eighteen (18) wells, including offset wells. Thereafter, Grantee shall continuously operate at least one drilling outfit until Grantee has drilled into the State lands a total number of wells equal to the nearest whole number obtained by dividing the total acreage of the State lands herein described by ten (10).
>
> The Grantee shall, however, be entitled to drill as many additional wells as Grantee desires.
>
> * * * * *

Petitioner's right to quitclaim, mentioned in the preceding paragraph, was set out in Section 9 of the Agreement for Easement No. 392, as follows:

> The Grantee, at any time after drilling offset wells required to be drilled under this agreement, may quitclaim this agreement as to all of the State lands embraced herein or as to any part or parts thereof, and in the event of a partial quitclaim, Grantee's obligations hereunder as to the number of wells

(other than offset wells) to be drilled shall be reduced proportionately; provided however, that Grantee shall be obligated to make payment of all rents, royalties and other obligations due and payable to the State accrued to the date of such quitclaim; and further, provided, however, that in the event Grantee quitclaims a portion of the State lands such portion quitclaimed shall be in a compact form and not less than ten (10) acres; and further, provided, that the Grantee at the request of the State shall grant to any lessee or subsequent grantee of such quitclaimed area, upon such terms and conditions as the State may prescribe, a right to the free use with Grantee of rights of way, easements, or other interests in the State lands acquired by this agreement, as may be necessary or convenient in connection with the operations in such quitclaimed area under a lease or subsequent easement.

In drilling the wells pursuant to the above agreement, petitioner incurred the following intangible drilling and development costs and charged its claimed share thereof to expense:

SOUTHWEST EXPLORATION COMPANY

Intangible Drilling and Development Costs on State Easement No. 392

Year	Total 100%	Lawson, et al. 10⅝%	Petitioner 89⅜%	Capitalized by Respondent as Depreciable	Capitalized by Respondent as Depletable
1938					
Offset wells	$149,181.50	$15,850.54	$133,330.96	$56,930.71	$ 76,400.25
1939					
Offset wells	100,293.97	10,656.23	89,637.74	27,404.75	86,278.10
Other wells	320,929.87	34,098.80	286,831.07	69,679.02	193,106.94
Totals	$421,223.84	$44,755.03	$376,468.81	$97,083.77	$279,385.04
1940	$205,834.10	$21,869.87	$183,964.23	$47,204.48	$136,759.75
1941	$253,625.69	$26,947.73	$226,677.96	$56,721.09	$169,956.87
1942	$176,944.24	$18,800.33	$158,143.91	$37,963.85	$120,180.06

Petitioner, in its returns for the first year in which intangible oil well drilling and development costs were incurred, exercised the option granted in the regulations to deduct such items from gross income as expenses. Respondent disallowed the deduction of such intangible expenses and capitalized them as items returnable through depletion or depreciation, as shown above. The first 11 wells drilled by petitioner during 1938 and 1939 pursuant to State Easement No. 392 offset existing wells of Standard Oil Company of California. As previously noted, petitioner is not now contesting the disallowance of the intangible drilling and development costs incurred in connection therewith. Thereafter, petitioner continued the drilling of wells in accordance with the terms of State Easement No. 392. As to wells drilled after December 31, 1942, the respondent has allowed petitioner to deduct 89⅜ per cent of all intangible drilling and development costs in accordance with applicable regulations.

Pursuant to certain conditions specified in Exhibit "A" attached to the above-mentioned Agreement for Easement No. 392, petitioner did not drill or deepen, nor was it required to drill or deepen, any wells prior to January 1, 1943. Petitioner developed a region known as the Jones Zone and drilled a number of wells in that zone. All the wells drilled by petitioner had their tops on the uplands and their bottoms under the ocean more than 200 feet from the mean high tide line. All of petitioner's production in the years involved came from the

property covered by Agreement for State Easement No. 392.

Certain provisions were made in the foregoing agreement relative to petitioner's failure to carry out any of the terms and conditions set forth therein. These provisions read, in part, as follows:

Section 2(n). * * * should the Grantee at any time during the term hereof be adjudged a bankrupt, either upon Grantee's voluntary petition in bankruptcy, or upon the involuntary petition of Grantee's creditors, or any of them, or should an attachment be levied and permitted to remain for an unreasonable length of time upon or against the interests, rights or privileges of Grantee in or to any oil, gas or other hydrocarbon substances produced from any well or wells drilled by Grantee upon said lands, then all of the interests, rights, and privileges of Grantee in and to all oil, gas or other hydrocarbon substances produced and saved from the State lands by reason of Grantee's operations thereon, shall immediately cease, terminate and end, and in such event the State shall have, and Grantee, by the acceptance thereof, hereby gives the State, the right, option and privilege to cancel and terminate this agreement and all of the terms and provisions granted hereby, and all of the rights and privileges of Grantee in and to or upon the State lands, and in and to any oil, gas or other hydrocarbon substances produced and saved from the State lands by reason of Grantee's operations thereon, and all of Grantee's rights and privileges granted by this Agreement shall immediately cease and terminate

and end up on the State so exercising its option in writing.

* * * * *

Section 13. If the Grantee shall fail to comply with the provisions of the Act so far as applicable or make default in the performance or observance of any of the terms, covenants and stipulations hereof, or of the rules and regulations of the State now promulgated, and all reasonable rules and regulations which may hereafter be promulgated, and such default shall continue for the period of thirty (30) days after written notice thereof to the Grantee, and no steps shall have been taken within that time, in good faith, to remedy said default, then the State may enter upon the premises of the Grantee and take possession of the same and all facilities, tools, equipment and supplies for the purpose of operating said wells of the Grantee until such time as all money defaults of the Grantee to the State have been fully satisfied, or if such default cannot be satisfied by the payment of money, then the State shall have the right and power to cancel this agreement or to close said well or wells which are not being conducted or operated in the manner prescribed by the provisions of this agreement, the rules and regulations of the State now promulgated, and reasonable rules and regulations of the State which may be hereafter promulgated; but this provision shall not be construed to prevent the exercise by the State of any legal or equitable remedy which the State might otherwise effect. The waiver of or failure of the State to act upon any particular cause of forfeiture

shall not prevent the cancellation and forfeiture of this agreement for any other cause of forfeiture or for the same causing occurring [sic] another time.

On August 25, 1938, petitioner entered into an agreement with Huntington Beach Company, Pacific Electic Railway Company, Pacific Electric Land Company, Bolsa Land Company, Bolsa Chica Gun Club and Standard Oil Company of California, as permittors for the permit referred to above, possession of which was a prerequisite to the acceptance of its bid for Easement No. 392. Under this agreement petitioner was permitted to go on the uplands belonging to the permittors, open the tops of its oil wells, drill into the land and under the land of the permittors, out under the ocean, and to place its derricks, machinery, etc. on the surface of the land. The agreement prohibited petitioner from bottoming any of its wells under the uplands, but required that all such wells be bottomed and completed so that all the perforated pipe at producing intervals should be located within the confines of the State land. As a matter of practice, Standard Oil Company required that all the bottoms be at least 200 feet off shore from the mean high tide line.

Also on August 25, 1938, petitioner entered into an agreement with the Huntington Beach Company, Pacific Electric Railway Company, Pacific Electric Land Company and Standard Oil Company of California by the terms of which it was agreed that the surface location and subsurface course through the uplands, to be drilled by petitioner from the uplands

into the State Easement, had to have Standard Oil Company's written approval. That contract was complied with in all respects. All of petitioner's wells have been drilled to conform with its agreement with the State and with the upland owners. There were no "filled lands" as that term is used in Article 6 of the State Lands Act of 1938.

On September 27, 1938, petitioner entered into an agreement with Pacific Electric Railway Company, Pacific Electric Land Company and Huntington Beach Company. Under this agreement petitioner agreed to pay to the upland owners, as rental for the rights and privileges given by them to petitioner under its agreements of August 25, 1938, as follows:

8. Southwest shall pay to Second Parties as rental an amount equal to the following percentages of the "net profits":

17.75 % to Huntington Beach Company,
1.576% to Pacific Electric Railway Company,
5.174% to Pacific Electric Land Company.

Said rental payments shall be made on or before the twenty-fifth day of the month immediately following the time when "net profits" arise in the operations herein referred to. * * *

The agreement of September 27, 1938, also contained the following provisions:

13. It is understood and agreed that nothing herein shall add to, modify, or limit the privileges given to Southwest by Second Parties and others in those certain agreements dated August 25, 1938, or the rights given to Southwest under said State Easement, nor shall any default hereunder by

Southwest cause a forfeiture of the rights or privileges given Southwest by Second Parties under said agreements of August 25, 1938.

* * * * *

19. This agreement shall not be construed to give Second Parties any right, title, or interest in said State Lands or in or under said State Easement, and said Southwest may, at any time, at its election, without any consent or participation by Second Parties, modify said State Easement or surrender, and terminate the same in accordance with the provisions thereof. In the event that Southwest shall assign its interest in State Easement, such assignment shall be made subject to the assumption by the assignee thereunder of all of the obligations of Southwest under this agreement.

* * * * *

22. This agreement and the two said agreements of August 25, 1938, and any and all rights of Southwest in or to the property covered thereby, shall terminate upon the expiration of said Easement No. 392 or any renewals, extensions, or modifications thereof. Upon such termination, Southwest shall proceed diligently to remove any and all facilities which it may have placed upon said uplands and shall forthwith restore said uplands as nearly as possible to the condition in which said premises existed prior to the commencement of operations thereon by Southwest. Southwest shall immediately upon such termination pay to Second Parties whatever sums of money which may then be due them.

* * * * *

23. It is the express intention of the parties hereto not to create a partnership relationship.

* * * * *

Opinion

Van Fossan, Judge: This case presents two questions. The first is whether petitioner may properly deduct the so-called intangible drilling costs of certain oil wells drilled by it during the years 1939 to 1942, inclusive.

Petitioner claims the right to the deduction here in dispute by virtue of the option granted in Regulations 111, Section 29.23 (m)-16.[1]

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[1] Regulations 111. Income Tax.

Sec. 29.23 (m)-16. Charges to capital and to expense in case of oil and gas wells.—(a) Taxable years beginning prior to January 1, 1943.—The provisions of this subsection apply only to taxable years beginning prior to January 1, 1943.

(1) Items chargeable to capital or to expense at taxpayer's option:

(i) Option with respect to intangible drilling and development costs in general: All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas, may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital account. Such expenditures have, for convenience been termed intangible drilling and development costs. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are

Respondent contends that the regulations cited and relied upon by petitioner are inapplicable to the present factual situation. He argues that the drilling of the wells in question constituted part of the consideration for the Agreement for State Easement No. 392.

The regulations in question apply to the so-called intangible costs incurred in connection with drilling wells on property, the title to which is held in fee or under a lease by the taxpayer-driller. They do not apply to such costs when the drilling is done on the land of another or as consideration for acquisition of an interest in the lands of others. Hardesty vs. Commissioner, 127 F. 2d 843; affirming 43 B.T.A. 245. Thus, if the wells in question were drilled as part of the consideration for the Easement Agreement, then the so-called intangible costs incident thereto are not deductible pursuant to the option contained in the aforementioned regulations. Rather,

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necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling and development items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Drilling and development costs shall not be excepted from the option merely because they are incurred under a contract providing for the drilling of a well to an agreed depth, or depths, at an agreed price per foot or other unit of measurement. [Emphasis supplied.]

they represent capital expenditures recoverable only through depletion allowances. F.H.E. Oil Company, 3 T.C. 13, affirmed 147 F. 2d 1002; F. F. Hardesty, 43 B.T.A. 245, affirmed 127 F. 2d 843; United States vs. Sentinel Oil Co., 109 F. 2d 854; State Consolidated Oil Company vs. Commissioner, 66 F. 2d 648; cert. denied, 290 U.S. 704. On the other hand, if such drilling was not a part of the consideration for the Easement Lease, then the expenses incurred in connection therewith are properly deductible as maintained by petitioner. The ultimate question is whether the drilling of the wells in question was part of the consideration by which petitioner acquired its interest in the leased premises. The answer to this question is dispositive of this issue.

Petitioner agrees with the foregoing statement of law. However, it contends that it was obligated to drill only the first eleven offset wells as consideration for the lease; that any wells drilled thereafter were so-called optional wells drilled on its own lease; that the drilling of the optional wells was not a condition precedent but was in the nature of a condition subsequent; that it had and exercised the option to charge the drilling costs to expenses; and that, therefore, it should be permitted the deductions in dispute.

We are entirely unimpressed by petitioner's argument. Rather, we feel that the provisions of the Easement Agreement support respondent's position and point up the fact that complete execution of the drilling program attached to and made a part of the

Agreement for Easement No. 392 was the primary consideration for the Agreement.

The prescribed drilling program clearly contemplated the full development of the entire 835 acres involved. It required petitioner to maintain continuous drilling operations until a total of 83 wells had been drilled. This requirement was subject only to petitioner's right to quitclaim the Agreement as to all the "State lands" embraced therein "* * * or as to any part or parts thereof * * *." In the event of a partial quitclaim pursuant to this arrangement, petitioner's obligations with respect to the number of wells to be drilled, other than offset wells, was proportionately reduced. Thus, petitioner's obligation could be alleviated only to the extent to which it was assumed by petitioner's grantee in any such quitclaim transaction.

In the event of petitioner's failure to continue and to complete the prescribed drilling program or to quitclaim the agreement to a party who could assume petitioner's obligations, provision was made in the Agreement whereby the State could re-enter the premises upon 30-days notice, cancel the Agreement, or exercise any legal or equitable remedy to which it might otherwise be entitled. Further, the Agreement also terminated should petitioner be adjudged a bankrupt or should an attachment be levied. Consequently, it appears that petitioner's right, title, or interest in and to the oil and gas in place vested only as and when the prescribed drilling program was completed. While petitioner itself was in on sense bound to continue the drilling and

development program set forth as a part of the Agreement, only by doing so could it acquire and retain any right, title, or interest under the Agreement. Clearly the acquisition of such rights was contingent upon petitioner's continued drilling and its completion of the prescribed number of producing wells.

As said above, the primary purpose of the Agreement for State Easement No. 392 was to procure the drilling of oil wells on, and the development of, the entire 835 acres covered by the lease. This was the essence of the transaction and constituted the consideration therefor. Accordingly, it matters not whether we regard petitioner's interest as vesting upon execution of the Agreement, subject to being divested for non-performance of conditions subsequent or upon completion of the number of producing wells prescribed in the drilling program. F.H.E. Oil Company, supra. Under either view, the drilling of the wells was the consideration for petitioner's interest in the gas and oil in place. In United States vs. Sentinel Oil Co., supra, the Court said, inter alia:

> Appellee attempts to distinguish the State Consolidated Oil case from the instant one, by the fact that in the former case title to the property was not to pass until after the property owner had received his $1,400 from the proceeds of the well, while in the instant case title passed upon the execution of the contract. We do not think that this distinction changes

the situation. In both cases the drilling expenditures were the consideration for the passing of title to the land.

The foregoing is opposite here.

We hold, therefore, that petitioner is not entitled to the deductions claimed. Respondent's action in disallowing such deductions is sustained.

The second question involves petitioner's right to a depletion deduction on the 24½ per cent of its net profits which it paid to certain upland owners. It was on and through the property of these owners that petitioner had located various "whipstock" wells for the production of gas and oil from the submerged lands located adjacent thereto.

As pointed out above, petitioner acquired the sole right to exploit the oil property in question by virtue of its 1938 agreement with the State of California. The terms of this agreement provided that any development of, or drilling into, the submerged lands covered thereby must be conducted from littoral or upland sites. This provision required as a condition precedent to the agreement that the requisite easements be procured from the owners of the adjacent uplands and that certification as to such action then be made in the form of an endorsement by the upland owners attached to the agreement as finally executed. In consideration of the necessary easement and certification petitioner agreed to pay to the upland owners involved an amount equal to 24½ per cent of its net profits.

Petitioner seeks to include the foregoing amount within its gross income subject to a deduction for depletion in accordance with sections 23 (m)[2] and 114 (b)(3),[3] Internal Revenue Code.

In order to determine whether petitioner is entitled to include the above amount within its gross income and then be allowed the depletion claimed, we would briefly recall the purpose and intent of the statutory allowance. Because of their inherent nature, oil and gas reserves, together with other mineral deposits, have been recognized and designated as wasting assets. Anderson vs. Helvering, 310 U.S.

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[2] Sec. 23. Deductions from Gross Income.
In computing net income there shall be allowed as deductions:
* * * * *
(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *

[3] Sec. 114. Basis for Depreciation and Depletion.
* * * * *
(b) Basis for Depletion.—
* * * * *
(3) Percentage depletion for oil and gas wells.—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * *

404. By this designation it is meant that a portion of the capital assets is consumed in the production of income through exploitation thereof. Helvering vs. Bankline Oil Company, 303 U.S. 362. Hence, Congress has granted the deduction in question as an equitable means of allowing a tax free return of the capital so consumed in the process of production. Anderson vs. Helvering, supra. It follows that the depletion deduction is allowable only to those who have a capital investment or economic interest in the oil or other mineral in place from which income is received by reason thereof. Kirby Petroleum Company vs. Commissioner, 326 U.S. 599; Burton-Sutton Oil Co., Inc. vs. Commissioner, 328 U.S. 25; Helvering vs. Bankline Oil Company, supra; United States vs. Spalding, 97 F. 2d 701. In determining whether a taxpayer has such an investment or interest no significance attaches to the particular legal form of the transaction creating the rights. Burton-Sutton Oil Co., Inc. vs. Commissioner, supra; Palmer vs. Bender, 287 U.S. 551; Lynch vs. Alworth-Stephens Co., 267 U.S. 364. It is enough that the taxpayer has acquired through any form of legal relationship the right to share in the oil produced. Palmer vs. Bender, supra. And a right to share in the profits from the sale of the oil following extraction is analogous to a right to share in the mineral itself. Helvering vs. Twin Bell Oil Syndicate, 293 U.S. 312; Anderson vs. Helvering, supra; Kirby Petroleum Company vs. Commissioner, supra; Burton-Sutton Oil Co., Inc. vs. Commissioner, supra. However, the term "economic interest" does not em-

brace a " * * * mere economic advantage derived from production through a contractual relation to the owner by one who has no capital investment in the mineral deposit * * *." Helvering vs. Bankline Oil Company, supra. On the contrary, it appears clearly that an allowance for depletion is warranted only where, by agreement between the parties, the taxpayer has obtained a capital interest in the oil and gas in place, to the severance and sale of which one must look for the return of capital consumed in that process. The right to share in the net receipts disassociated from an economic interest therein does not entitle the holder thereof to an allowance for depletion. Kirby Petroleum Co. vs. Commissioner, supra; Burton-Sutton Oil Co., Inc. vs. Commissioner, supra; Anderson vs. Helvering, supra; Helvering vs. O'Donnell, 303 U.S. 370.

In the instant case, it cannot be gainsaid that petitioner possessed an economic interest in the oil involved. The dispute arises as to whether petitioner was the sole owner of such an interest during the taxable years. Petitioner contends that it acquired and has retained the entire economic interest conveyed under the Agreement for State Easement No. 392. Respondent, on the other hand, rejects petitioner's contention and argues on brief that the upland owners, by their endorsement of the Agreement for State Easement No. 392, became parties thereto; that such owners thereby acquired an economic interest in the oil and gas in place directly from the State; that the income received therefrom by the upland owners is includible in their gross

income, rather than that of petitioner, subject to the depletion deduction here in dispute.

We have no desire or purpose to enter into the dispute as to the claims to rights in the submerged coastal areas (see U.S. vs. California, 332 U.S. 19 [1947]) and what we say herein is not intended in any way to pass upon the competing interests asserted in that litigation or growing out of the cited decision.[4]

Prior to 1938 the State allowed such oil property as is here involved to be developed and operated from piers, islands or barges. In that year the State Legislature passed the so-called State Lands Act of 1938 pursuant to the provisions of which such methods of drilling and development were prescribed. This Act called for each well thereafter drilled in the submerged lands to be drilled from filled lands or slant drilled from an upland or littoral drill site. All equipment, derricks, machinery, appliances, surface structures and operations were required to be located upon such site. Section 87 (a), Chap. 5, Calif. Stats., Ex. Sess., 1938. This statute was passed as a regulatory measure applying to the

[4]Since the decision in United States vs. California, supra, extraction of oil from the California submerged costal lands, pursuant to leases previously granted by the State, has been authorized by stipulations executed by the State and the United States. See Hearings before Senate Committee on Interior and Insular Affairs on S. 155, 81st Cong., 1st Sess., pp. 279-282; Hearings on S. J. Res. 195, 81st Cong., 2d Sess., pp. 22-26; S. J. Res. 20, 82nd Cong., 1st Sess., pp. 13-17.

development and exploitation of the coastal oil deposits. Obviously, the Act was not meant to convey any economic interests therein to anyone. Nor do we believe that it so did. Consequently, in so far as the 835 acres here involved are concerned, any present economic interests therein were acquired by virtue of, and simultaneously with, the Agreement for State Easement No. 392 or through some transaction subsequent thereto.

The State and petitioner were the only parties to the body of this agreement. The granting clause therein granted to petitioner the sole and "* * * exclusive right to drain, take, receive, extract, remove, and produce from the * * * lands oil, gas, and other hydrocarbon substances * * *." This right is not made subject to any pre-existing rights and there is no provision therein for income derived from oil production to be shared with third parties. Within its four corners, then, it would appear that such economic interests as were passed therein, were acquired by petitioner alone. Nor do we feel that further interests were obtained by other parties outside thereof because of the endorsement attached thereto but not included therein by any reference. There also appears to have been no such acquisition by third parties through any action on the part of the petitioner. There are in evidence three instruments whereby petitioner acquired the requisite upland easements. In return for such easements the owners therof were granted the right to 24½ per cent of the net profits derived from petitioner's operations. But we do not feel that such

parties thereby acquired a capital interest in the oil in place. One such agreement specifically provides that it shall not be so construed as to be a transfer of "* * * any right, title or interest in [the] * * * State lands or in or under [the] * * * State Easement, * * *"; and that it was the express intention of the parties thereto not to create a partnership relationship. Further, these parties were never owners nor lessees of the leased property. They did not, and could not, during the taxable years, have produced oil therefrom. Nor did they at any time during the period have any capital investment in the oil or gas in place. Cf. United States vs. Spalding, supra. It would seem that the above-mentioned agreements could be terminated or modified at any time petitioner's agreement with the State of California was so terminated or modified. Under these circumstances it would appear that the upland drill sites and the agreements granting them to petitioner could be abandoned and terminated by petitioner at any time the State of California might see fit to change its policy toward drilling in the submerged coastal lands.

In summation, then, it is our view that petitioner was the sole recipient under the Agreement for State Easement No. 392 of an economic interest in the oil property involved; that at no time thereafter was any economic interest therein acquired by third parties; that the amounts equal to 24½ per cent of petitioner's net profits were not paid as royalties or rents based upon an economic interest therein; and that, therefore, these amounts are includible in pe-

titioner's gross income subject to the statutory allowance for depletion. Accordingly, we so hold. Respondent's claim for increased deficiencies, affirmatively set out in his amended answer, will be considered in the recomputation under Rule 50.

Reviewed by the Court.

Decision will be entered under Rule 50.

The Tax Court of the United States
Washington

Docket No. 24872

SOUTHWEST EXPLORATION COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Court's Findings of Fact and Opinion, promulgated September 10, 1952; the respondent filed a proposed computation of tax on January 5, 1953, and petitioner filed an acquiescence therein on January 6, 1953, now, therefore, it is

Ordered and decided: That there are deficiencies in income tax for the years 1939, 1940, 1941, 1942, 1943, 1944 and 1945 in the respective amounts of $32,1[illegible]8, $31,271.85, $50,057.09, $34,075.82, $46,767.42, $31,822.17 and $47,892.34; that there are deficiencies in declared value excess profits tax for the years 1939 and 1940 in the respective amounts of $20,455.80 and $5,973.03; that there are overpay-

ments in declared value excess profits tax for the years 1942, 1944 and 1945 in the respective amounts of $6,348.53, $2,982.50 and $8,764.91, which amounts were paid after the mailing of the notice of deficiency; that there is a deficiency in excess profits tax for the year 1940 in the amount of $24,545.60; that there is an overpayment in excess profits tax for the year 1941 in the amount of $19,730.83, which amount was paid after the mailing of the notice of deficiency; that there is an overpayment in excess profits tax for the year 1942 in the amount of $24,735.03, which amount was paid after the mailing of the notice of deficiency; that there is an overpayment in excess profits tax for the year 1944 in the amount of $55,781.76, of which amount the sum of $21,679.64 was paid within three years before the execution of an agreement, which agreement was executed within three years from the time the return was filed by the taxpayer, and the amount of $34,102.12 was paid after the mailing of the notice of deficiency; and that there is an overpayment of $51,249.47 in excess profits tax for the year 1945, of which amount $29,030.16 was paid within three years before the execution of an agreement, which agreement was executed within three years from the time the return was filed by the taxpayer, and the amount of $22,219.31 was paid after the mailing of the notice of deficiency.

/s/ ERNEST H. VAN FOSSAN,
Judge.

Entered January 8, 1953.

In the United States Court of Appeals
for the Ninth Circuit

T. C. Docket No. 24872

COMMISSIONER OF INTERNAL REVENUE,
Petitioner on Review,

vs.

SOUTHWEST EXPLORATION COMPANY,
Respondent on Review.

PETITION FOR REVIEW

To the Honorable Judges of the United States Court of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by The Tax Court of the United States on January 8, 1953, pursuant to its Findings of Fact and Opinion promulgated September 10, 1952 (18 T. C. No. 122) ordering and deciding:

"That there are deficiencies in income tax for the years 1939, 1940, 1941, 1942, 1943, 1944 and 1945 in the respective amounts of $32,114.88, $31,271.85, $50,057.09, $34,075.82, $46,767.42, $31,822.17 and $47,892.34; that there are deficiencies in declared value excess profits tax for the years 1939 and 1940 in the respective amounts of $20,455.80 and $5,973.03; that there are overpayments in declared value excess profits tax for the years 1942, 1944 and 1945 in the respective amounts of $6,348.53, $2,982.50 and $8,764.91, which amounts were paid after the

mailing of the notice of deficiency; that there is a deficiency in excess profits tax for the year 1940 in the amount of $24,545.60; that there is an overpayment in excess profits tax for the year 1941 in the amount of $19,730.83, which amount was paid after the mailing of the notice of deficiency; that there is an overpayment in excess profits tax for the year 1942 in the amount of $24,735.03, which amount was paid after the mailing of the notice of deficiency; that there is an overpayment in excess profits tax for the year 1944 in the amount of $55,781.76, of which amount the sum of $21,679.64 was paid within three years before the execution of an agreement, which agreement was executed within three years from the time the return was filed by the taxpayer, and the amount of $34,102.12 was paid after the mailing of the notice of deficiency; and that there is an overpayment of $51,249.47 in excess profits tax for the year 1945, of which amount $29,030.16 was paid within three years before the execution of an agreement, which agreement was executed within three years from the time the return was filed by the taxpayer, and the amount of $22,219.31 was paid after the mailing of the notice of deficiency."

This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code, as amended.

I.

Jurisdiction

The respondent on review, Southwest Exporation Company (sometimes hereinafter called the "tax-

payer"), is a corporation organized under the laws of the State of California on June 20, 1933, and has its principal office and place of business in Los Angeles, California. The taxpayer filed its corporate income tax, declared value excess profits tax and excess profits tax returns for the calendar years 1938, 1939, 1940, 1941, 1942, 1943, 1944 and 1945 with the Collector of Internal Revenue for the Sixth District of California (now the Director of Internal Revenue, Los Angeles District) whose office is located at Los Angeles, California, which collection district is within the jurisdiction of the United States Court of Appeals for the Ninth Circuit, wherein this review is sought. This case involves deficiencies in income tax for the years 1939 through the year 1945; deficiencies in declared value excess profits tax for the years 1939, 1940, 1942, 1944 and 1945; and deficiencies in excess profits tax for the years 1940 through 1945, except for the year 1943.

II.

Nature of Controversy

The facts relating to the matters under review herein were largely set forth in stipulations and documentary exhibits attached thereto.

The following facts are succinctly set forth to explain the background for the question upon review, which involves the right of the taxpayer to a depletion deduction on the percentage (24½%) of its net profits which it paid to certain upland owners under agreements dated August 25 and September 27, 1938, hereinafter referred to, who permitted it to

locate various "whipstock" wells for the production of gas and oil from the submerged lands located adjacent thereto.

Prior to 1938 the State of California permitted State lessees and oil operators to develop and operate submerged coastal oil deposits from piers, islands and barges. This practice resulted in waste petroleum products interfering with fishing and bathing along the beaches of southern California. In 1938 the State Legislature passed the State Lands Act of 1938 under which the State Lands Commission was appointed with power to lease the submerged lands in such manner as to prevent the oil operations from despoiling the beaches. This Act called for each well thereafter drilled in the submerged lands to be drilled from filled lands or slant-drilled from an upland or littoral drill site. All equipment, derricks, machinery, appliances, surface structures and operations were required to be located upon such site. (Section 87(a), Chap. 5, Calif. Stats., Ex. Sess., 1938). From August 8 to 13, 1938, this Commission published a Notice of Intention to Receive Offers to enter into an agreement for extraction of oil and gas from an area of submerged lands situated off Huntington Beach, California. The area involved was approximately 835 acres and was the area which eventually was covered by State Easement No. 392.

The notice of intention provided:

"In any notice of intention to lease tide or submerged lands, the commission may include a re-

quirement that each prospective bidder, as a condition precedent to the consideration of his bid and in addition to the other qualifications required by this chapter, shall present evidence satisfactory to the commission of his present ability to furnish all necessary sites and rights of way for all operations contemplated under the provisions of the proposed lease. In such event the commission shall reject the bids of all bidders who fail to qualify as provided by this section."

The taxpayer, which had been incorporated for the purpose of developing and producing oil from submerged tidelands near Huntington Beach, California, if and when a lease or easement could be obtained, made a bid and submitted same on August 30, 1938. The taxpayer was the successful bidder for the aforementioned State Easement No. 392, which provided for the right to exploit the oil property covered thereby, and on September 26, 1938, it entered into an agreement with the State Lands Commission which provided for the payment of royalties and rent to the state, and for drilling and producing oil and gas. The terms of this agreement provided that any development of, or drilling into, the submerged lands covered thereby must be conducted from littoral or upland sites. This provision required as a condition precedent to the agreement that the requisite easements be procured from the owners of the adjacent uplands and that certification as to such action then be made in the form of an endorsement by the upland owners attached to the agreement as finally executed.

On August 25, 1938, taxpayer entered into an agreement with Huntington Beach Company, Pacific Electric Railway Company, Pacific Electric Land Company, Bolsa Land Company, Bolsa Chica Gun Club and Standard Oil Company of California, as permittors for the permit referred to above, possession of which was a prerequisite to the acceptance of its bid for Easement No. 392. Under this agreement taxpayer was permitted to go on the uplands belonging to the permittors, open the tops of its oil wells, drill into the land and under the land of the permittors, out under the ocean, and to place its derricks, machinery, etc., on the surface of the land. The agreement prohibited taxpayer from bottoming any of its wells under the uplands, but required that all such wells be bottomed and completed so that all the perforated pipe at producing intervals should be located within the confines of the State land. As a matter of practice, Standard Oil Company required that all the bottoms be at least 200 feet off shore from the mean high tide line.

Also on August 25, 1938, taxpayer entered into an agreement with the Huntington Beach Company, Pacific Electric Railway Company, Pacific Electric Land Company, and Standard Oil Company of California by the terms of which it was agreed that the surface location and subsurface course through the uplands, to be drilled by taxpayer from the uplands into the State easement, had to have Standard Oil Company's written approval. That contract was complied with in all respects. All of taxpayer's wells have been drilled to conform with its agreement

with the State and with the upland owners. There were no "filled lands" as that term is used in article 6 of the State Lands Act of 1938.

On September 27, 1938, taxpayer entered into an agreement with Pacific Electric Railway Company, Pacific Electric Land Company, and Huntington Beach Company. Under this agreement taxpayer agreed to pay to the upland owners, as rental for the rights and privileges given by them to taxpayer under its agreements of August 25, 1938, as follows:

"Southwest shall pay to Second Parties as rental an amount equal to the following percentages of the "net profits":

17.75 % to Huntington Beach Company,
1.576% to Pacific Electric Railway Company,
5.174% to Pacific Electric Land Company.

Said rental payments shall be made on or before the twenty-fifth day of the month immediately following the time when "net profits" arise in the operations herein referred to.

The taxpayer therefore agreed to pay the upland owners an amount equal to 24½ per cent of its net profits from its oil and gas operations. Due to certain provisions regarding "chargeable expenses", no "net profits" arose such as would incur a liability for the so-called rental payments until in the year 1941. In 1941 and subsequent years, payments or accruals to the upland owners were made.

The taxpayer sought to include the payments to

the upland owners within its gross income subject to a deduction for depletion in accordance with Section 23(m) and 114(b)(3) of the Internal Revenue Code. The taxpayer contends that the payments were merely rentals which are deductible as operating expenses in computing "net income from the property" as defined in Section 29.23(m)-1(g) of the regulations and that the payments affect its depletion deductions only in so far as they might limit the 27½ per cent of gross income to 50 per cent of net income.

The taxpayers further contend that the acquisition of a right to share in the net profits by one who prior thereto had no interest in the land or oil as an owner, lessee, sub-lessee, or assignee, stands in a different position with respect to depletion allowance than the owner, lessor, sub-lessor, or assignor, who reserves such right to share in the net profits from production. It is the position of the Commissioner that this is a distinction without a difference under the Supreme Court cases of Burton-Sutton Oil Co. vs. Commissioner (1946), 328 U.S. 25, and Kirby Petroleum Co. vs. Commissioner (1946), 326 U.S. 599.

In computing the percentage depletion allowable under Section 29.23(m)-4 of Regulations 111 to the taxpayer in the years 1941 through 1945, the Bureau considered that the "net profits" paid to the upland owners under the agreements of August 25 and September 27, 1938, were amounts which were payable out of the gross oil production and thus excludible from "gross income" as defined in Section 29.23(m)-

1(f), upon which the 27½ per cent depletion allowance is to be made.

The Commissioner's position is based in part upon the conclusion that the several agreements, which they endorsed, were integral parts of one transaction and since the upland owners endorsed such agreements and their endorsement was essential to the operations, the upland owners were parties thereto and made actual investment in the oil and gas under the submerged tideland and obtained an economic interest therein by devoting their contiguous lands to development purposes and therefore the "net profits" received by them were derived from a depletable interest and should accordingly be excluded from the taxpayer's gross income. By the same token, the upland owners would be entitled to depletion, which they have claimed on their returns or by claims filed therefor.

The final determination of the question herein resolves whether or not depletion allowance on the oil and gas produced from the "state lands" here involved is to be allocated between the taxpayer (and its joint venturers) and the upland owners.

The taxpayer contends that it acquired and has retained the entire economic interest conveyed to it by the State Easement No. 392, and that the upland owners were strangers to the lease or State Easement and they had no capital investment in the mineral deposit and they accordingly received a mere economic advantage derived from production through their contractual relationship with it.

It is submitted that the Tax Court clearly and properly stated the rules applicable to the transaction herein (on page 12 of its opinion when it made the following summary:

"* * * Because of their inherent nature, oil and gas reserves, together with other mineral deposits, have been recognized and designated as wasting assets. Anderson vs. Helvering, 310 U. S. 404. By this designation it is meant that a portion of the capital asset is consumed in the production of income through exploitation thereof. Helvering vs. Bankline Oil Co., 303 U. S. 362. Hence, Congress has granted the deduction in question as an equitable means of allowing a tax free return of the capital so consumed in the process of production. Anderson vs. Helvering, supra. It follows that the depletion deduction is allowable only to those who have a capital investment or economic interest in the oil or other mineral in place from which income is received by reason thereof. Kirby Petroleum Co. vs. Commissioner, 326 U. S. 599; Burton-Sutton Oil Co. vs. Commissioner, 328 U. S. 25; Helvering vs. Bankline Oil Co., supra; United States vs. Spalding, 97 F. 2d 701. In determining whether a taxpayer has such an investment or interest no significance attaches to the particular legal form of the transaction creating the rights. Burton-Sutton Oil Co. vs. Commissioner, supra; Palmer vs. Bender, 287 U. S. 551; Lynch vs. Alworth-Stephens Co., 267 U. S. 364. It is enough that the taxpayer has acquired through any form of legal relationship the right to share in the oil produced. Palmer vs. Bender, supra.

And a right to share in the profits from the sale of the oil following extraction is analogous to a right to share in the mineral itself. Helvering vs. Twin Bell Oil Syndicate, 293 U. S. 312; Anderson vs. Helvering, supra; Kirby Petroleum Co. vs. Commissioner, supra; Burton-Sutton Oil Co. vs. Commissioner, supra. * * *"

The Tax Court, however, concluded and found that the taxpayer was the sole recipient under the Agreement for State Easement No. 392 of an economic interest in the oil property involved; that at no time thereafter was any economic interest therein acquired by third parties; that the amounts equal to 24½ per cent of taxpayer's net profit were not paid as royalties or rents based upon an economic interest therein; and that, therefore, these amounts are includible in taxpayer's gross income subject to the statutory allowance for depletion.

It is submitted that the findings and conclusions of the Tax Court are contrary to Kirby Petroleum Co. vs. Commissioner of Internal Revenue, supra, and Burton-Sutton Oil Co. vs. Commissioner of Internal Revenue, supra, to the effect that a holder of net profit rights dependent for realization solely upon the extraction and sale of oil in place, possesses a depletable economic interest in such oil, and are accordingly erroneous. Further, that the holding of the Tax Court is contrary to administrative regulations and practice with reference to the allowances and allocations of depletion (G.C.M. 22730, 1941—1 C.B. 214.)

III.

Statement of Points

A complete Statement of Points upon which the Commissioner intends to rely as a basis of his petition for review will be separately filed with the record on review to be filed herein.

Wherefore, the Commissioner petitions that said findings of fact and opinion and decision of The Tax Court of the United States be reviewed by the United States Court of Appeals for the Ninth Circuit; that a transcript of the record be prepared in accordance with the law and the rules of said Court and be transmitted to the Clerk of the said Court for filing, and that appropriate action be taken to the end that the erorrs herein complained of may be reviewed and corrected by said Court.

/s/ H. BRIAN HOLLAND,
Assistant Attorney General.

/s/ CHARLES W. DAVIS,
Chief Counsel, Bureau of Internal Revenue, Counsel for Petitioner on Review.

Of Counsel:

C. R. MARSHALL,
Special Attorney,
Bureau of Internal Revenue.

[Endorsed]: T.C.U.S. Filed March 23, 1953.

[Title of U. S. Court of Appeals and Cause.]

STATEMENT OF POINTS

Comes now the Commissioner of Internal Revenue, petitioner on review in the above-entitled cause, by and through his attorneys H. Brian Holland, Assistant Attorney General, and Charles W. Davis, Chief Counsel, Bureau of Internal Revenue, and hereby states that he intends to rely upon the following points in this proceeding:

That the Tax Court of the United States erred:

1. In holding and finding that the taxpayer was the sole recipient under the Agreement for State Easement No. 392 of an economic interest in the oil and gas property involved thereunder.

2. In holding and finding that at no time after the acquisition by taxpayer of State Easement No. 392 was any economic interest therein acquired by third parties.

3. In holding and deciding that the amounts equal to 24½ per cent of taxpayer's net profits were not paid as royalties or rents based upon an economic interest therein.

4. In holding and finding that the upland owners obtained no economic interest by reason of the endorsement to the agreements of August 25, 1938, and September 27, 1938.

5. In holding and finding that because taxpayer acquired the requisite upland easements from the upland owners and they were granted therefor the

right to 24½ per cent of the net profits derived from taxpayer's tideland operations, the upland owners did not thereby acquire a capital interest in that oil and gas in place.

6. In holding and deciding that the payments in amounts equal to 24½ per cent of the taxpayer's net profits are includible in taxpayer's gross income subject to statutory allowance for percentage depletion.

7. In holding and deciding that the upland owners' right to share in the net profits of the taxpayer were disassociated from an economic interest therein and accordingly they were not entitled to an allowance for depletion thereon.

8. In holding and finding that the upland owners did not at any time during the period involved have any capital investment in the oil or gas in place in the properties involved with respect to State Easement No. 392.

9. In failing to hold and find that the upland owners, by their endorsement of the agreement for State Easement No. 392, became parties thereto.

10. In failing to hold and find that the upland owners by their endorsement of the agreements of August 25, 1938, and September 27, 1938, made investments in and acquired an economic interest in the oil and gas in place.

11. In failing to hold and decide that the net profits received by the upland owner from the tax-

payer is includible in their gross income, rather than the taxpayers, subject to depletion deduction.

12. In failing to hold and find that taxpayer is not entitled to include in its gross income 24½ per cent of its net income which it paid to the upland owners on and through whose properties it had "whipstock" wells for the purpose of producing oil from agreement for State Easement No. 392, and is therefore not entitled to depletion thereon.

13. In failing to hold and decide that the upland owners are entitled to percentage depletion with respect to the 24½ per cent net profit payment received from taxpayer.

14. In failing to hold and decide that the upland owners' right to a percentage of the net profits of the taxpayer were dependent for realization solely upon the extraction and sale of mineral in place.

15. In failing to hold and decide because the upland owners' right to a percentage of the net profits of the taxpayer were dependent for realization solely upon the extraction and sale of mineral in place, the upland owners possessed a depletable interest in such minerals in place.

16. In that its opinion and decision are contrary to the holdings of the United States Supreme Court in Burton-Sutton Oil Company, Inc., vs. Commissioner of Internal Revenue (1946), 328 U. S. 25, and Kirby Petroleum Company vs. Commissioner of Internal Revenue (1946), 326 U. S. 599.

17. In that its opinion and decision are contrary

to the law and the regulations and are not supported by substantial evidence of record.

18. In ordering and deciding that there are overpayments in declared value excess profits tax for the years 1942, 1944 and 1945 in the respective amounts of only $6,348.53, $2,982.50 and $8,764.91, which amounts were paid after the mailing of the notice of deficiency.

19. In ordering and deciding that there is an overpayment in excess profits tax for the year 1941 in the amount of $19,730.83, which amount was paid after the mailing of the notice of deficiency.

20. In ordering and deciding that there is an overpayment in excess profits tax for the year 1942 in the amount of $24,735.03, which was paid after the mailing of the notice of deficiency.

21. In ordering and deciding that there is an overpayment in excess profits tax for the year 1944 in the amount of $55,781.76, of which amount the sum of $21,679.64 was paid within three years before the execution of an agreement, which agreement was executed within three years from the time the return was filed by the taxpayer and the amount of $34,102.12 was paid after the mailing of the notice of deficiency.

22. In ordering and deciding that there is an overpayment of $51,249.47 in excess profits tax for the year 1945, of which amount $29,030.16 was paid within three years before the execution of an agreement, which was executed within three years from

the time the return was filed by the taxpayer and the amount of $22,219.31 was paid after the mailing of the notice of deficiency.

/s/ H. BRIAN HOLLAND,
Assistant Attorney General.
/s/ CHARLES W. DAVIS,
Chief Counsel, Bureau of Internal Revenue, Counsel for Petitioner on Review.

[Endorsed]: T.C.U.S. Filed May 13, 1953.

The Tax Court of the United States
Washington

[Title of Cause.]

CERTIFICATE

I, Victor S. Mersch, Clerk of The Tax Court of the United States do hereby certify that the foregoing documents 1 to 32 inclusive, constitute and are all of the original papers and proceedings (except Respondent's Exhibits Q and T, admitted in Evidence, Respondent's Exhibits R and S, marked for Identification only, and Exhibits 1-A through 16-P, attached to the Stipulation of Facts, which are separately certified and forwarded under separate cover), on file in my office as the original and complete record in the proceedings before The Tax Court of the United States in the above-entitled proceedings and in which the Respondent in The Tax Court proceedings has initiated an appeal as

above numbered and entitled, together with a true copy of the docket entries in said Tax Court proceedings, as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the said Court at Washington, in the District of Columbia, this second day of June, 1953.

[Seal] /s/ VICTOR S. MERSCH,
Clerk, The Tax Court of the
United States.

[Endorsed]: No. 13875. United States Court of Appeals for the Ninth Circuit. Commissioner of Internal Revenue, Petitioner, vs. Southwest Exploration Company, a corporation, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed June 15, 1953.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit.

No. 13875

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

SOUTHWEST EXPLORATION COMPANY,
Respondent.

STIPULATION

It is hereby stipulated by the parties, subject to the approval of the Court, that such of the exhibits of the stipulation of facts and such part of the Reporter's Official Report of Proceedings and such part of the evidence introduced into the case that has not been incorporated in the printed record may be referred to by counsel and considered by the Court just as though the same was included in the printed record.

Date: June 30, 1953.

/s/ H. BRIAN HOLLAND,
Assistant Attorney General, Counsel for Petitioner

/s/ MELVIN D. WILSON,
Counsel for the Respondent

So Ordered:

/s/ WM. HEALY,
/s/ WM. E. ORR,
United States Circuit Judges

[Endorsed]: Filed July 15, 1953. Paul P. O'Brien, Clerk.

125 [Minute entry of argument and submission, December 6, 1954 (omitted in printing.)]

126 In United States Court of Appeals for the Ninth Circuit

Minute entry of order directing filing of opinion and filing and recording of judgment

March 7, 1955

Ordered that the typewritten opinion this day rendered by this Court in above cause be forthwith filed by the Clerk, and that a Judgment be filed and recorded in the minutes of the Court in accordance with the opinion rendered.

127 In United States Court of Appeals for the Ninth Circuit

No. 13,875

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

SOUTHWEST EXPLORATION COMPANY, A CORPORATION, RESPONDENT

On Petition to Review a Decision of the Tax Court of the United States

Before STEPHENS, *Circuit Judge*, CHAMBERS, *Circuit Judge*, and HARRISON, *District Judge*

Opinion

March 7, 1955

Per Curiam:

In this appeal, the only question brought to us from the Tax Court is who is entitled to depletion for oil that is extracted from beneath the ocean. The Tax Court held that upland owners from whose lands the slant wells were drilled into the pool of oil, under the ocean, are not entitled to participate in the depletion for oil thus extracted. The Commissioner of Internal Revenue appeals asserting that the upland owners, comprising the Huntington Beach Co., Pacific Electric Ry. Co., Pacific Electric Land Co., The Bolsa Land Co., the Bolso Chica Gun Club, and the Standard Oil Co., upon whose lands the wells were drilled and through whose property the rights of way and easements were granted for the drilling of such wells are entitled to a portion of the depletion

for oil extracted under the permit granted by the State to the taxpayer.

We are in accord with the ruling of the Tax Court, [1 T. C. 961] and adopt that part of the Tax Court's opinion reading as follows:

128 "The second question involves petitioner's right to a depletion deduction on the 24½ percent of its net profits which it paid to certain upland owners. It was on and through the property of these owners that petitioner had locate! various 'whipstock' wells for the production of gas and oil from the submerged lands located adjacent thereto.

"As pointed out above, petitioner acquired the sole right to exploit the oil property in question by virtue of its 1938 agreement with the State of California. The terms of this agreement provided that any development of, or drilling into, the submerged lands covered thereby must be conducted from littoral or upland sites. This provision required as a condition precedent to the agreement that the requisite easements be procured from the owners of the adjacent uplands and that certification as to such action then be made in the form of an endorsement by the upland owners attached to the agreement as finally executed. In consideration of the necessary easements and certification petitioner agreed to pay to the upland owners involved an amount equal to 24½ per cent of its net profits.

"Petitioner seeks to include the foregoing amount within its gross income subject to a deduction for depletion in accordance with section 23 (m)[2] and 114 (b) (3),[3] Internal
129 Revenue Code.

"In order to determine whether petitioner is entitled to include the above amount within its gross income and then be allowed the depletion claimed, we would briefly recall the purpose and intent of the statutory allowance. Because of their inherent nature, oil and gas reserves, together with other mineral deposits, have been recognized and designated as wasting assets. Ander-

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[2] Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the secretary. * * *

[3] Sec. 114. Basis for Depreciation and Depletion.

* * * * * * *

(b) Basis for Depletion.—

* * * * * * *

(3) Percentage depletion for oil and gas wells. In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * *

son v. Helvering, 310 U. S. 404. By this designation it is meant that a portion of the capital assets is consumed in the production of income through exploitation thereof. Helvering v. Bankline Oil Company, 303 U. S. 362. Hence, Congress has granted the deduction in question as an equitable means of allowing a tax free return of the capital so consumed in the process of production. Anderson v. Helvering, supra. It follows that the depletion deduction is allowable only to those who have a capital investment or economic interest in the oil or other mineral in place from which income is received by reason thereof. Kirby Petroleum Company v. Commissioner, 326 U. S. 599; Burton-Sutton Oil Co. Inc. v. Commissioner, 328 U. S. 25; Helvering v. Bankline Oil Company, supra; United States v. Spalding, 97 F. 2d 701. In determining whether a taxpayer has such an investment or interest no significance attaches to the particular legal form of the transaction creating the rights. Burton-Sutton Oil Co., Inc. v. Commissioner, supra; Palmer v. Bender, 287 U. S. 551; Lynch v. Alsworth-Stephens Co., 267 U. S. 364. It is enough that the taxpayer has acquired through any form of legal relationship the right to share in the oil produced. Palmer v. Bender, supra. And a right to share in the profits from the sale of the oil following extraction is analogous to a right to share in the mineral itself. Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312; Anderson v. Helvering, supra; Kirby Petroleum Company v. Commissioner, supra; Burton-Sutton Oil Co., Inc. v. Commissioner, supra. However, the term 'economic interest' does not embrace a '* * * mere economic advantage derived from production through a contractual relation to the owner by one who has no capital investment in the mineral deposit * * *.' Helvering v. Bankline Oil Com-
130 pany, supra. On the contrary, it appears clearly that an allowance for depletion is warranted only where, by agreement between the parties, the taxpayer has obtained a capital interest in the oil and gas in place, to the severance and sale of which one must look for the return of capital consumed in that process. The right to share in the net receipts disassociated from an economic interest therein does not entitle the holder thereof to an allowance for depletion. Kirby Petroleum Co. v. Commissioner, supra; Burton-Sutton Oil Co., Inc. v. Commissioner, supra; Anderson v. Helvering, supra; Helvering v. O'Donnell, 303 U. S. 370.

"In the instant case, it cannot be gainsaid that petitioner possessed an economic interest in the oil involved. The dispute arises as to whether petitioner was the sole owner of such an interest during the taxable years. Petitioner contends that it acquired and has retained the entire economic interest conveyed under the

of the necessary easements and certification petitioner agreed to pay to the upland owners involved an amount equal to 24½ per cent of its net profits.

"Petitioner seeks to include the foregoing amount within its gross income subject to a deduction for depletion in accordance with section 23 (m)[2] and 114 (b) (3),[3] Internal
129 Revenue Code.

"In order to determine whether petitioner is entitled to include the above amount within its gross income and then be allowed the depletion claimed, we would briefly recall the purpose and intent of the statutory allowance. Because of their inherent nature, oil and gas reserves, together with other mineral deposits, have been recognized and designated as wasting assets. Ander-

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[2] Sec. 23. Deductions from Gross Income.
In computing net income there shall be allowed as deductions:

* * * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the secretary. * * *

[3] Sec. 114. Basis for Depreciation and Depletion.

* * * * *

(b) Basis for Depletion.—

* * * * *

(3) Percentage depletion for oil and gas wells.—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * *

Agreement for State Easement No. 392. Respondent, on the other hand, rejects petitioner's contention and argues on brief that the upland owners, by their endorsement of the Agreement for State Easement No. 392, became parties thereto; that such owners thereby acquired an economic interest in the oil and gas in place directly from the State; that the income received therefrom by the upland owners is includible in their gross income, rather than that of petitioner, subject to the depletion deduction here in dispute.

"We have no desire or purpose to enter into the dispute as to the claims to rights in the submerged coastal areas (see U. S. v. California, 332 U. S. 19 [1947]) and what we say herein is not intended in any way to pass upon the competing interests asserted in that litigation or growing out of the cited decision.[4]

131 "Prior to 1938 the State allowed such oil property as is here involved to be developed and operated from piers, islands or barges. In that year the State Legislature passed the so-called State Lands Act of 1938 pursuant to the provisions of which such methods of drilling and development were prescribed. This Act called for each well thereafter drilled in the submerged lands to be drilled from filled lands or slant drilled from an upland or littoral drill site. All equipment, derricks, machinery, appliances, surface structures and operations were required to be located upon such site. Section 87 (a), Chap. 5, Calif. Stats., Ex. Sess., 1938. This statute was passed as a regulatory measure applying to the development and exploitation of the coastal oil deposits. Obviously, the Act was not meant to convey any economic interests therein to anyone. Nor do we believe that it so did. Consequently, in so far as the 835 acres here involved are concerned, any present economic interests therein were acquired by virtue of, and simultaneously with, the Agreement for State Easement No. 392 or through some transaction subsequent thereto.

"The State and petitioner were the only parties to the body of this agreement. The granting clause therein granted to the petitioner the sole and "* * * exclusive right to drain, take, receive, extract, remove, and produce from the * * * lands oil, gas, and other hydrocarbon substances * * *." This right is not made subject to any pre-existing rights and there is no provision therein for income derived from oil production to be shared with third parties. Within its four corners, then, it would appear that such

[4] Since the decision in United States v. California, supra, extraction of oil from the California submerged coastal lands, pursuant to leases previously granted by the State, has been authorized by stipulations executed by the State and the United States. See Hearings before Senate Committee on Interior and Insular Affairs on S. 155, 81st Cong., 1st Sess., pp. 279-282; Hearings on S. J. Res. 195, 81st Cong., 2d Sess., pp. 22-26; S. J. Res. 20, 82d Cong., 1st Sess., pp. 13-17.

economic interests as were passed therein, were acquired by petitioner alone. Nor do we feel that further interests were obtained by other parties outside thereof because of the endorsement attached thereto but not included therein by any reference. There also appears to have been no such acquisition by third parties through any action on the part of the petitioner. There are in evidence three instruments whereby petitioner acquired the requisite upland easements. In return for such easements the owners thereof were granted the right to 24½ percent of the net
132 profits derived from petitioner's operations." But we do not feel that such parties thereby acquired a capital interest in the oil in place. One such agreement specifically provides that it shall not be so construed as to be a transfer of "* * * any right, title or interest in [the] * * * State lands or in or under [the] * * * State Easement, * * *"; and that it was the express intention of the parties thereto not to create a partnership relationship. Further, these parties were never owners nor lessees of the leased property. They did not, and could not, during the taxable years, have produced oil therefrom. Nor did they at any time during the period have any capital investment in the oil or gas in place. Cf. United States *v.* Spalding, supra. It would seem that the above-mentioned agreements could be terminated or modified at any time petitioner's agreement with the State of California was so terminated or modified. Under these circumstances it would appear that the upland drill sites and the agreements granting them to petitioner could be abandoned and terminated by petitioner at any time the State of California might see fit to change its policy toward drilling in the submerged coastal lands.

"In summation, then, it is our view that the petitioner was the sole recipient under the Agreement for State Easement No. 392 of an economic interest in the oil property involved; that at no time thereafter was any economic interest therein acquired by third parties; that the amounts equal to 24½ percent of petitioner's net profits were not paid as royalties or rents based upon an economic interest therein; and that, therefore, these amounts are includible in petitioner's gross income subject to the statutory allowance for depletion. Accordingly, we so hold. Respondent's claim for increased deficiencies, affirmatively set out in his amended answer, will be considered in the recomputation under Rule 50."

Judgment of the Tax Court from which the appeal was taken is affirmed.

[File endorsement omitted.]

This Act called for each well thereafter drilled in the submerged lands to be drilled from filled lands or slant drilled from an upland or littoral drill site. All equipment, derricks, machinery, appliances, surface structures and operations were required to be located upon such site. Section 87 (a), Chap. 5, Calif. Stats., Ex. Sess., 1938. This statute was passed as a regulatory measure applying to the development and exploitation of the coastal oil deposits. Obviously, the Act was not meant to convey any economic interests therein to anyone. Nor do we believe that it so did. Consequently, in so far as the 835 acres here involved are concerned, any present economic interests therein were acquired by virtue of, and simultaneously with, the Agreement for State Easement No. 392 or through some transaction subsequent thereto.

"The State and petitioner were the only parties to the body of this agreement. The granting clause therein granted to the petitioner the sole and '* * * exclusive right to drain, take, receive, extract, remove, and produce from the * * * lands oil, gas, and other hydrocarbon substances * * *.' This right is not made subject to any pre-existing rights and there is no provision therein for income derived from oil production to be shared with third parties. Within its four corners, then, it would appear that such

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[4] Since the decision in United States v. California, supra, extraction of oil from the California submerged coastal lands, pursuant to leases previously granted by the State, has been authorized by stipulations executed by the State and the United States. See Hearings before Senate Committee on Interior and Insular Affairs on S. 155, 81st Cong., 1st Sess., pp. 279–282; Hearings on S. J. Res. 195, 81st Cong., 2d Sess., pp. 22–26; S. J. Res. 20, 82d Cong., 1st Sess., pp. 13–17.

133 In United States Court of Appeals for the Ninth Circuit

No. 13,875

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

SOUTHWEST EXPLORATION COMPANY, A CORPORATION, RESPONDENT

Judgment

Filed and entered March 7, 1955

Upon petition to review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the decision of the said Tax Court in this cause be, and hereby is affirmed.

[File endorsement omitted.]

134 [Clerk's certificate to foregoing transcript omitted in printing.]

135 Supreme Court of the United States

No. ———, October Term, 1954

[Title omitted.]

Order extending time to file petition for Writ of Certiorari

Upon consideration of the application of counsel for petitioner(s), it is ordered that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including August 4, 1955.

WM. O. DOUGLAS,
Associate Justice of the Supreme Court of the United States.

Dated this 27th day of May, 1955.

No. 286, October Term, 1955

[Title omitted.]

Order allowing certiorari

Filed October 10, 1955

The petition herein for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.